



Current Developments in  
Monetary and Financial Law

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Volume

4

International  
Monetary  
Fund

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Monetary and Financial Law

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International Monetary Fund

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## PREFACE

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The Legal Department and the Institute of the International Monetary Fund (IMF) held their ninth biennial seminar for legal advisers of central banks of member countries from May 24 to June 4, 2004. As in previous years, presentations were made by officials of the IMF and other international organizations, officials of central banks and regulatory agencies, representatives of the private sector, lawyers, and scholars. The papers published in this volume are based on these presentations. The views they express by the authors should not be attributed to the IMF or to any institution with which the authors are affiliated.

The seminar covered a broad range of topics, which are reflected in this volume, including activities of the IMF, sovereign debt restructuring, money laundering and the financing of terrorism, financial system and banking supervision, conflicts of interest and market discipline in the financial sector, insolvency, and other issues relating to central banking. Given the widespread electronic availability of treaties, legislation, and other resource materials, appendixes included in this volume are limited to extracts that may not be easily attained otherwise and that will aid readers in their overall understanding of the ideas presented.

I wish to express our gratitude to a number of people for organizing the seminar and for their work on this publication. Roy Baban and Seng Chee Ho of the Legal Department played a key role in the seminar's preparation and organization. Glenn Gottselig of the Legal Department and Marina Primorac of the External Relations Department provided editorial expertise. Deidre Davis, Luz Lemus, and Olga Penova provided administrative assistance with the seminar, and Sarah Underwood and Duangratai Jayanan were responsible for the composition of the publication.

SEAN HAGAN  
*The General Counsel*  
*Director of the Legal Department*

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**I. DEVELOPMENTS IN INTERNATIONAL LAW  
AND AT THE  
INTERNATIONAL MONETARY FUND**

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FRANÇOIS GIANVITI

In press articles and ministerial communiqués, the International Monetary Fund (IMF) is often listed among international financial institutions. Actually, the primary function of the IMF is not to provide financial assistance to its members but to attain certain objectives in international monetary relations. It is first and foremost a monetary institution.

To achieve its objectives in international monetary relations (essentially exchange rate stability and liberalization of payments and transfers for current international transactions), the IMF can use different instruments. One of them is the provision of financial assistance for balance of payments problems. By making foreign exchange available to its members in times of crisis, the IMF provides “them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.”<sup>1</sup> Another instrument is of a regulatory rather than financial nature: the IMF monitors the compliance by its members with certain obligations specified in the Articles of Agreement. These obligations constitute a code of good monetary conduct that IMF members are required to observe.

By joining the membership of the IMF, the members have accepted these obligations and, to that extent, limited their monetary sovereignty. In exchange, they have received certain benefits. One of them is that other members too have agreed to limit their sovereignty for the sake of international cooperation and for the common good of all. Another benefit is that in times of crisis they will have access to financial assistance from the IMF if they meet the required conditions.



As most countries are now members of the IMF, it may be said that full monetary sovereignty exists only in those few countries that are not members of the IMF. In addition to being members of the IMF, some countries are members of regional monetary unions that have limited their monetary sovereignty even beyond the limitations imposed by the IMF's Articles. For instance, in the European Monetary Union, a common currency has replaced the national currencies. Similarly, the West African and the Central African Monetary Unions have their respective common currencies; the member states do not issue separate national currencies. These African unions are even more integrated than the European Monetary Union; for example, they have no national central banks, and they have a common system of exchange controls for their financial relations with countries outside each union. Accordingly, there are today different levels of monetary sovereignty.

This chapter examines the different components of monetary sovereignty and assesses the extent to which these components have or have not been restricted by rules of international law. One of the issues to be addressed will be the issue of conflicts of sovereignty. As sovereign countries are equal subjects of international law, the sovereignty of one cannot infringe on the sovereignty of another. In practice, however, it is not always easy to know where the sovereignty of one ends and the sovereignty of another begins.

Monetary sovereignty includes essentially three exclusive rights for a given state:<sup>2</sup>

- the right to issue currency, that is, coins and banknotes that are legal tender within its territory;<sup>3</sup>
- the right to determine and change the value of that currency; and
- the right to regulate the use of that currency, or any other currency, within its territory.

The first and third rights correspond to the role of money as a medium of payment. The second right reflects the role of money as a unit of account. Conceptually, the two functions may be separated: a monetary unit of account may be represented by coins and notes bearing a different name (e.g., in France before the Revolution,<sup>4</sup> and recently in the European Monetary Union during the interim period af-

ter the euro became the official currency and while national currencies were still being used).

Moreover, for purposes of the third right (use of currency), the concept of currency is usually expanded to cover not only coins and banknotes denominated in local or foreign currency but also other means of payment denominated in any currency (essentially, bank balances).

## **The Issuance of Currency**

### **Principles**

The right to issue currency in a territory may be exercised by the state that has sovereignty over the territory; it may be delegated to a central bank or other entity (e.g., currency board); several states may delegate their power to issue currency to a common central bank (e.g., the Central Bank of West African States, the European Central Bank, etc.).

In the exercise of its monetary sovereignty, a state may determine the name of its currency and the face value and physical features of the banknotes and coins denominated in that currency. It may also decide to issue a new currency, which will then require a determination of a rate of conversion from the old currency to the new one.<sup>5</sup>

The right to issue currency has economic implications that go far beyond the supply of coins and banknotes to a country's economy. A central bank vested with the exclusive power to issue currency within a given territory may extend credit to operators within that territory, in particular commercial banks, which will use it to finance their own activities, including by extending credit to their own customers. Through the opening of lines of credit or rediscount facilities or open market operations, the central bank will regulate the volume and cost of credit, if not directly, at least indirectly, within that territory. These operations will usually not result in the issuance of coins and banknotes but mainly in book entries; however, the effect on the economy will be the same, because claims in the books of the central bank can be converted into currency. The central bank's right to issue currency allows it to conduct the country's monetary policy.

A state's right to issue its currency is protected against foreign states. Counterfeiting another state's currency would be seen as an infringement of its sovereignty. Therefore, a state may not counterfeit another state's currency.<sup>6</sup>

### **Exceptions**

Does the prohibition against counterfeiting another state's currency apply in times of war? There have been instances of such practices.<sup>7</sup>

In the case of belligerent occupation, it is common practice for the occupant to use its own currency or local currency for payments to local residents. A more difficult question is whether the Hague Regulations of 1907, which apply in situations of belligerent occupations, implicitly prohibit the occupying state from changing the currency of the occupied country. In post-war Germany, the Allied Powers replaced the reichsmark by the deutsche mark; one argument was that the Hague Regulations did not apply because Germany had disappeared as a sovereign state. During the occupation of Iraq in 2003, a new currency was issued by the central bank of Iraq pursuant to a regulation enacted by the Coalition Provisional Authority; however, Iraq was still regarded as a sovereign state—it had lost only the exercise of its sovereignty (absence of an internationally recognized government), and the United Nations (UN) Security Council had recognized the applicability of the Hague Regulations in Iraq during the occupation.<sup>8</sup> The introduction of a new currency is not per se a violation of the Hague Regulations because a belligerent occupant may take economic measures for the public good of the occupied country. The legality of that measure will depend on whether it was actually taken for that public good and in particular on whether or not it was of a confiscatory nature.<sup>9</sup>

## **The Valuation of Currency**

### **Principles**

The state that issues a currency may determine and change the value of that currency. It is also free not to determine a particular value for its currency (e.g., in terms of other currencies).

A delegation by a state to a central bank or other entity of the right to issue currency does not necessarily confer the right to determine and change the value of the currency. This right may be retained by the state.

Under the par value system of the IMF's original Articles of Agreement, the par value of a member's currency was determined in terms of gold, which created an obligation for the member to maintain exchange rates within specified margins around parity; the parity was the relationship between any two currencies based on their respective par values. The par value could be changed unilaterally by the member. Beyond a threshold, the IMF's concurrence for a change had to be sought. If it were refused and the par value was nevertheless changed (e.g., in the case of France in 1948), the member became ineligible to use the IMF's resources, but the change was not regarded as a breach of obligation under the IMF's Articles. Sovereignty was recognized even in that case.

Since a change in the value of a currency is not a breach of international law, a state is not liable for its consequences on holders of its currency, or on creditors or debtors that have claims or obligations denominated in that currency.<sup>10</sup> The issue has arisen in cases of devaluation;<sup>11</sup> it could equally arise in cases of revaluation. There could be an exception to this rule if the state "pursues a deliberate course of injuring or discriminating against foreigners."<sup>12</sup>

The right to change the value of the currency is sometimes understood as conferring the right to prohibit maintenance of value clauses (e.g., gold clauses).

### **Exceptions**

Under the present Articles of Agreement of the IMF, there are certain limitations on the members' right to determine or change the value of their currency:

- a member may not determine the value of its currency in terms of gold; any other valuation is permitted, but none is required (i.e., a member may decide to let its currency float);<sup>13</sup>

- a member may not manipulate exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members;<sup>14</sup> and
- a member may not engage in multiple currency practices<sup>15</sup> (e.g., broken cross rates).

### **Extraterritorial Effects**

Extraterritorial effects of legislation may be understood in two different ways. Under the first meaning, a country decides that its laws will apply to (and its courts will have jurisdiction over) acts occurring outside its territory. In the “Lotus” case,<sup>16</sup> the Permanent Court of International Justice held that, in principle and subject to limited exceptions under international law, a state could exercise its jurisdiction, through legislative and judicial action, to facts occurring outside its territory (e.g., outside its territorial waters).

Under a second meaning, a law has extraterritorial effects if the courts of other states are required under international law to give effect to that law. In principle, and subject to certain exceptions (e.g., under international treaties), there is no such obligation. It is for the private international law of the forum (i.e., the national law of the court exercising jurisdiction over the case) to determine the applicability of foreign laws by its courts.

When the case is decided by an international court, it will look to generally accepted principles of private international law for a solution to the choice of law issue. For instance, in the Serbian and Brazilian loans cases in 1929,<sup>17</sup> the Permanent Court of International Justice, while recognizing that the *lex monetae* determines the value of the currency, held that the effects of a devaluation on a contract raised questions of private international law and that it was eventually for the *lex contractus* to determine the effects of a devaluation on the contract.

International law allows each state to change the value of its currency. In general, the principle known as nominalism will lead to a recognition abroad that a devaluation or revaluation operated by the *lex monetae* affects the value of obligations denominated in that currency, but there may be exceptions. The most common issue is

whether the parties to a contract have implicitly or explicitly agreed that their obligations would not be affected by such changes, for instance, by inserting a maintenance of value clause in terms of another currency or gold. In such cases, the extent to which the devaluation or revaluation is given effect by a foreign court will depend on the rules of private international law of the forum (i.e., *lex contractus*, public policy of the forum (*ordre public*), or other rules).

In the 1950 decision in *Messageries Maritimes*, a case involving bonds issued in Canada by a French company and denominated in Canadian gold dollars, the French *Cour de cassation* refused to give effect to a Canadian law devaluing the Canadian dollar and avoiding gold clauses in existing contracts on the grounds that, as a matter of *ordre public* and notwithstanding the mandatory provisions of the law governing the contract, rules of French law on international contracts did not allow the court to recognize the effect of foreign monetary laws on international contracts.<sup>18</sup> In a subsequent development of that case, a further decision of the *Cour de cassation* on October 29, 1964 reached the same result, this time on the grounds that French law was the *lex contractus*.<sup>19</sup>

The replacement of an old currency by a new currency raises similar issues. Foreign courts will usually recognize the conversion of obligations denominated in the old currency into obligations denominated in the new currency. The continuity of contracts will not be affected. In some cases, however, legislation has been passed to dispel any doubt on this outcome. For example, this issue arose in the United States after the European Union's (EU's) decision to substitute the European Currency Unit (ECU) with the euro at a rate of one to one, and, on the basis of that rate, to gradually substitute the euro for the national currencies of the members of the European Monetary Union (EMU), which were previously valued in terms of the ECU. New York and some other states decided to enact legislation to recognize the rate of conversion from ECU to euro and the substitution of the euro for the EMU members' currencies. It was an unprecedented action, due to the concern that some market participants might initiate litigation to challenge, if not the change itself, at least its application to their contracts.<sup>20</sup>

The right to regulate maintenance of value clauses is not really an attribute of the right to change the value of the currency. It applies

regardless of the currency being used as the unit of account. The European Council's regulation of June 17, 1997, substituting the ECU with the euro recognized the validity of such clauses as a possible exception to the official 1 ECU = 1 euro rate of conversion.

The question in practice is what law governs maintenance of value clauses in international contracts. In the Norwegian loans case,<sup>21</sup> the International Court of Justice applied Norwegian law as the *lex contractus* to gold clauses in loans issued by Norway, thus allowing the sovereign debtor to release itself from its contractual obligations by amending its own laws. Clearly, this creates an incentive for creditors not to agree to the application of the sovereign debtor's laws to their contracts. In the Serbian and Brazilian loans cases,<sup>22</sup> the sovereign debtor's law was not the *lex contractus*. French law was applied as the *lex contractus*, thus validating the gold clause, notwithstanding the fact that French law was also the *lex monetae* and was the cause of the devaluation of the currency in which the loans were denominated. The Court found that the rule under French law was that maintenance of value clauses were always valid in international contracts, and that was the rule applied by the Court.

## The Use of Currency

### Principles

A state may regulate the use of its currency and of other currencies within its territory. It may regulate payments, impose exchange controls, prohibit the making or receipt of payments and transfers in foreign currency for domestic and international transactions, and so forth. It may limit the scope of legal tender, for example, by requiring that payments above a certain amount be made by checks or transfers (to avoid tax evasion).

The regulation of currency includes all means of payment (including bank balances) denominated in that currency.

### Exceptions

Exchange restrictions imposed by one state have an adverse effect on cross-border transactions and, thus, on the interests of other states. Therefore, various international treaties limit the parties' right to re-

strict international payments and transfers (EU, Organization For Economic Cooperation and Development (OECD), World Trade Organization (WTO), IMF). Under the IMF Articles, members may restrict capital movements but need IMF approval for restrictions on the making of payments and transfers for current international transactions.<sup>23</sup> The OECD has adopted two codes of liberalization for its members: one for current invisible operations and the other for capital movements. The EU has liberalized current and capital movements. The treaties administered by the WTO (the General Agreement on Tariffs and Trade and the General Agreement on Trade in Services) also contain rules on liberalization of exchange restrictions.

Conversely, there may be instances in which a state is under an international obligation to impose trade and/or exchange restrictions against another country. This is the case when the UN Security Council, acting under Chapter VII of the UN Charter, requires UN members to impose economic sanctions that include exchange restrictions (Article 41 of the UN Charter).<sup>24</sup> States imposing exchange restrictions pursuant to a Security Council resolution must notify the IMF of the restrictions if they are subject to IMF approval (i.e., restrictions on the making of payments or transfers for current international transactions).<sup>25</sup> Faced with the threat of international terrorism, the UN Security Council has now adopted a broader interpretation of its powers under Chapter VII of the UN Charter. It has decided to impose economic sanctions not only against states but also against individuals and entities (terrorists and terrorist organizations) for the preservation of peace.<sup>26</sup> See, for instance, Resolutions No. 1267 (1999)<sup>27</sup> and 1333 (2000)<sup>28</sup> concerning the Taliban, 1373 (2001)<sup>29</sup> on the prevention and suppression of the financing of terrorists acts, and 1390 (2002)<sup>30</sup> and 1526 (2004)<sup>31</sup> on Al-Qaida and the Taliban. These sanctions usually include freezes of assets and other restrictions.

### **Extraterritorial Effects**

A state may prohibit the use of its currency abroad, for example, by persons under its jurisdiction, or more generally any use of its currency for payments abroad. There seems to have been no example of a state requiring the use of its currency abroad, except in cases of occupation of a foreign territory.



Whether other states must recognize the extraterritorial effect of such laws or more generally give effect to the laws of a foreign state on the use of its currency raises difficult questions.<sup>32</sup>

(1) The recognition of another state's exchange controls may be based on the forum's principles of private international law (*lex loci solutionis*, *lex contractus*, Article 7 of the Rome Convention on contractual obligations, act of state doctrine, comity), but the counter-argument in some countries is that foreign public laws are not to be given effect, even to the extent that they affect only contractual obligations. Article VIII, Section 2(b) of the IMF Articles imposes a limited obligation of cooperation against violations of other countries' exchange controls. However, the restrictive interpretation of that provision in major financial centers (New York, London) and its non-application to capital transfers in Germany show the reluctance of national courts to recognize other countries' exchange controls.<sup>33</sup>

(2) The obligation of cooperation imposed by Article VIII, Section 2(b) is generally seen as an exception to general principles of public international law. Otherwise, there would be no need for it in an international treaty. Nevertheless, some have argued that a country's regulation of the use of its own currency abroad is an attribute of its sovereignty and must be recognized by foreign countries as a general principle of public international law.<sup>34</sup> This principle would not only make Article VIII, Section 2(b) superfluous but also impose obligations exceeding the scope of that provision. The consequences would be particularly important for those countries whose national courts have taken a restrictive interpretation of Article VIII, Section 2(b). In practice, however, there is no evidence that such a far-reaching obligation has been recognized as a consequence of the monetary sovereignty of other countries, even in cases where the extraterritorial application of the *lex monetae* was also based on personal jurisdiction over one of the parties to the contract. This dual jurisdictional basis was used in U.S. freezes of official Iranian and, later, Libyan assets, which have both given rise to litigation. U.S. jurisdiction was based on both the use of the U.S. dollar and the U.S. nationality of the banks in which the deposits were held outside the United States. In 1989, in the *Bankers' Trust* case, the English judge refused to give effect to the U.S. freeze over official Libyan assets deposited in a U.K. branch of a U.S. bank.<sup>35</sup>

(3) A related question is whether the issuer of a currency may object to the use of that currency as legal tender abroad, or as unit of account for deposits in foreign banks, by insisting that its currency not be used for such purposes without its consent. Again, a state may enact legislation, or make representations to other states, to that effect, but there would be no obligation for foreign states or their national courts to give effect to such laws or representations as an extraterritorial attribute of that state's sovereignty. The territorial sovereignty of the state of the forum would take precedence.<sup>36</sup>

### Conclusion

Through customary law, doctrinal sources, judicial decisions, and treaties, a body of international law has been developed that defines the contours of monetary sovereignty. Its attributes have been identified and limitations have been introduced. The remaining issues are essentially related to the extraterritorial effects of monetary sovereignty. With respect to those effects, there have been attempts to expand the scope of public international law for a recognition of the *lex monetae* beyond the issuer's territory. Clearly, these extraterritorial effects are in conflict with the sovereignty of other states. Absent a rule of international law requiring a state to give effect to a foreign state's *lex monetae*, the principle is that it may refuse to give it any effect. This will be a matter to be decided in accordance with the private international law of the forum.

## Notes

<sup>1</sup> IMF, *Articles of Agreement of the International Monetary Fund*, Article I(v), <http://www/imf.org/external/pubs/ft/aa/index/htm>.

<sup>2</sup> On the attributes of monetary sovereignty, see F.A. Mann, *The Legal Aspect of Money*, 5th edition (Oxford: Clarendon Press, 1992), at 460–78; D. Carreau, *Souveraineté et coopération monétaire internationale* (Paris: LGDJ, 1970), at 15–97; G. Burdeau, “L’exercice des compétences monétaires par les Etats,” *Academy of International Law, Recueil des cours* (1988-V), at 223–49.

<sup>3</sup> On the distinction between currency (as legal tender) and “private money” (including “electronic money”), see M. Laine, “La monnaie privée,” *Revue Trimestrielle de Droit Commercial et de Droit Economique*, 2004, at 227.

<sup>4</sup> “Livre,” “sou,” and “denier” were units of account. “Franc,” “louis,” and “écu” were gold or silver coins. The relationship between the units of account and the coins varied over time, as did the gold or silver content of the coins. For instance, in May 1726, the value of the gold louis was raised from 20 to 24 livres and the silver écu from 5 to 6 livres; see R. Sédillot, *Le Franc, Histoire d’une monnaie des origines à nos jours* (Paris: Sirey, 1953), at 77. Initially a gold coin, the franc became a silver coin in the sixteenth century; until 1602, 1 franc was worth 1 livre, and the two terms could be used as synonyms.

<sup>5</sup> See *infra* the section entitled “The Valuation of Currency.”

<sup>6</sup> This is according to customary international law and the Geneva Convention of April 20, 1929, for the Suppression of Counterfeiting Currency.

<sup>7</sup> See Mann, *supra* note 2, at 481.

<sup>8</sup> Resolution 1483, op. para. 5, UN SCOR, 58th Sess., 4761st mtg. UN Doc. S/RES/1483 (2003).

<sup>9</sup> On the various options offered to a belligerent occupant, see Mann, *supra* note 2, at 481–87.

<sup>10</sup> See Mann, *supra* note 2, at 464.

<sup>11</sup> U.S. Foreign Claims Settlement Commission, Zuk Claim, November 5, 1956, *International Law Reports*, Vol. 26 (1958-II), at 284; H. Booyens, “Devaluation as an Exercise of Monetary Sovereignty and a Basis for State Liability,” *South African Yearbook of International Law*, Vol. 18 (1992–93), at 89–104.

<sup>12</sup> See U.S. Foreign Claims Settlement Commission, Zuk Claim, November 5, 1956, *International Law Report*, Vol. 26 (1958-II), at 285. For other examples, see Mann, *supra* note 2, at 469–71.

<sup>13</sup> IMF, *Articles of Agreement of the International Monetary Fund*, Article IV, Section 2(b), <http://www.imf.org/external/pubs/ft/aa/index.htm>.

<sup>14</sup> *Id.* Article IV, Section 1(iii).

<sup>15</sup> *Id.* Article VIII, Section 3.

<sup>16</sup> *France v. Turkey*, 1927 PCIJ, Series A, No. 10.

<sup>17</sup> *Brazilian Loans case (France v. Brazil)* 1929 PCIJ Series A, No. 21. *Serbian Loans case*, 1929 PCIJ Series A, Nos. 20/21.

<sup>18</sup> *Messageries Maritimes*, *Clunet* 1950, at 1196.

<sup>19</sup> *Clunet* 1965, at 637, obs. Goldman.

<sup>20</sup> See Michael Gruson, “The Introduction of the Euro and Its Implications for Obligations Denominated in Currencies Replaced by the Euro,” 21 *Fordham International Law Journal* (1997), at 65–108; James H. Freis, Jr., “Continuity of Contracts After the Introduction of the Euro: The United States Response to European Economic and Monetary Union,” 53 *Business Lawyer* (1998), at 701–66.

<sup>21</sup> *France v. Norway* (July 6, 1957), 1957 ICJ Reports 9.

<sup>22</sup> *Supra* note 17.

<sup>23</sup> IMF, *Articles of Agreement of the International Monetary Fund*, Article VIII, Section 2(a), <http://www.imf.org/external/pubs/ft/aa/index.htm>.

<sup>24</sup> See, e.g., Security Council Resolution No. 661 (1990) (imposing such sanctions against Iraq after the invasion of Kuwait).

<sup>25</sup> Restrictions imposed solely for the preservation of national or international security, once notified to the IMF, are deemed to be approved unless the IMF, within 30 days, informs the member that it is not satisfied that the restrictions are imposed solely to preserve such security. Decision No. 144-(52/51), August 14, 1952, reprinted in IMF, *Selected Decisions and Selected Documents of the International Monetary Fund*, 29th Issue (Washington: IMF, 2004), at 462–63.

<sup>26</sup> See IMF Legal Department, *Suppressing the Financing of Terrorism* (Washington: IMF, 2003), at 14.

<sup>27</sup> UN SCOR 54th Sess., 4051st mtg., UN Doc. S/INF/155 (1999).

<sup>28</sup> UN SCOR 55th Sess., 4251st mtg., UN Doc. S/INF/156 (2000).

<sup>29</sup> UN SCOR 59th Sess., 4385th mtg., UN Doc. S/INF/57 (2001).

<sup>30</sup> UN SCOR 57th Sess., 4452nd mtg., UN Doc. S/RES/1390 (2002).

<sup>31</sup> UN SCOR 59th Sess., 4908th mtg., UN Doc. S/RES/1526 (2004).

<sup>32</sup> See Mann, *supra* note 2, at 479–87. According to Mann, “apart from treaties, it would at present not be possible to maintain that customary public international law imposes upon the State the general duty of affording protection to the monetary systems of the other members of the family of nations. The existence of such a duty could be asserted only if the development of international law had progressed so far as to outlaw all activities injurious to a foreign state or even to demand the adoption of positive measures to safeguard a foreign state’s interests. This is not the present position.”

<sup>33</sup> See F. Gianviti, “Le contrôle des changes étranger devant le juge national,” 69 *Revue critique de droit international privé* (1980), at 479–502 and 659–703; “The Fund Agreement in the Courts,” in *Current Legal Issues Affecting Central Banks*, Vol. 1 (Washington: IMF, 1992), at 1–13 and Comment by P. Francotte, at 14–23; and A. S. Huguenin, *L’application du contrôle des changes étranger par le juge national* (Zurich: Schulthess, 2000).

<sup>34</sup> In favor of the extraterritorial effect of U.S. executive orders freezing holdings of U.S. dollars in foreign banks, see Carreau, “La Souveraineté de l’Etat à la fin du xxe siècle: mythe ou réalité,” in *Souveraineté étatique et marchés internationaux à la fin du 20ème siècle, Mélanges en l’honneur de Philippe Kahn* (Paris: Litec, 2000), at 499, para. 28.

<sup>35</sup> *Libyan Arab Foreign Bank v. Bankers Trust Company* (1989), Q.B. 728. For a similar view on the U.S. freeze of Iranian assets, see F. Gianviti, “Le blocage des avoirs officiels iraniens par les Etats-Unis (executive order du 14 novembre 1979),” 69 *Revue critique de droit international privé* (1980), at 279–303.

<sup>36</sup> See F. Gianviti, “Use of a Foreign Currency under the IMF’s Articles of Agreement,” in *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington: IMF, 2005), at 817–28.

**HECTOR ELIZALDE**

The experience of the pre–World War II years showed that, together with trade restrictions, exchange restrictions had a great damaging effect in the development and growth of world trade and thus on global prosperity. Exchange restrictions and competitive exchange depreciations had supplanted the system of multilateralism and automatism of the theoretical gold standard and had contributed greatly to international friction.

It became a common practice for many countries in the 1930s to establish different rates of exchange for different commodities to stimulate exports by making them cheaper in foreign markets while at the same time making the import of similar or other goods expensive in the domestic market and hence uncompetitive. It was also rather common for countries to conclude bilateral trade and payments agreements through which increased imports were exchanged for increased exports. These agreements usually contemplated fixed rates of exchange below the official rates and provided that the balances originating in the payments for the exports would be used to pay for imports from the other partner country, thus creating a fragmented international trade and payments system. Other mechanisms frequently used involved the direct rationing of foreign exchange by making it available only for payments of goods or commodities declared essential or with priority, while other payments would be met only if there was a surplus of exchange.

With this in mind, and in order to avoid the problems that had arisen in the intervening period between the two wars, which had been due in great part to the lack of international cooperation on monetary matters, the International Monetary Fund (IMF) was created, *inter alia*:

- “to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems”;
- “to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciations”; and
- “to assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.”<sup>1</sup>

To achieve these purposes, members of the IMF assumed a series of obligations and the organization was provided with some powers and also with resources that could be made temporarily available to members to provide them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

Leaving aside the obligations established under Article IV of the IMF’s Articles of Agreement by the Second Amendment following the demise of the par value system, this chapter will focus on the obligations undertaken by members in order to establish a system of unrestricted payments and transfers for current international transactions.

### **Exchange Controls**

To assist in the establishment of a multilateral system of payments with respect to current transactions between members and in the elimination of foreign exchange restrictions, which, as mentioned above, is one of the IMF’s purposes, members assumed some specific obligations and the organization was given some specific powers. For instance, all exchange control regulations of a member must be communicated to the IMF (Article VIII, Section 5(a)(xi)). In addition, some exchange controls may not be imposed by a member without prior approval by the organization.

A distinction is made under the IMF’s Articles between exchange restrictions and other exchange control measures, which are a broader

concept. A verification procedure for payments by resident debtors to nonresident creditors, or for the purchase of foreign currency by residents going abroad, is part of a country's exchange controls, but it is not a restriction. If, however, the full amount requested for the payment or the purchase cannot be obtained because of a regulation imposing a ceiling, or because of an administrative decision denying the application, there is a restriction. Similarly, if the verification procedure imposes undue delays, there is a restriction.

A second distinction is made between restrictions affecting capital movements and restrictions affecting current transactions. Restrictions on international capital movements can be imposed by a member without the IMF's approval (Article VI, Section 3). These restrictions can be selective: the member may impose restrictions on capital transfers to one member or several members (for instance, within the European Union).

## **Definition and Conceptual Issues Regarding Exchange Restrictions and Multiple Currency Practices**

### **The Concept of Exchange Restrictions**

Under Article VIII, Section 2(a), a member may not impose restrictions on the making of payments and transfers for current international transactions without the (prior) approval of the IMF.

#### ***Scope***

As already mentioned, the concept of exchange restriction is narrower than the concept of exchange control and has a limited scope. While exchange control regulations encompass all regulations pertaining to the acquisition, holding, or use of foreign exchange, or to the use of domestic or foreign currency in international payments or transfers as such, exchange restrictions are limited to exchange measures that affect "the making of payments and transfers for current international transactions."

First, Article VIII, Section 2(a) applies only to payments and transfers for international transactions, that is, transactions between



residents of different countries; it does not apply to domestic transactions, that is, transactions between residents of the same country.

Second, Article VIII, Section 2(a) imposes on IMF members an obligation toward their own residents. Members must allow, or not impede, their residents purchasing goods or services from nonresidents, or engaging in other current international transactions, to acquire and use the needed foreign exchange to make payment in settlement of those transactions. A member must not unduly delay, limit, or prevent any of its residents from obtaining the foreign currency that they need for making payments to nonresidents in settlement of current international transactions.

Third, Article VIII, Section 2(a) also imposes an obligation on IMF members toward nonresidents. Nonresidents that have recently acquired balances of the country's currency as a result of current international transactions must be permitted to transfer, or must not be impeded from transferring, those balances (i.e., to convert them into a currency of their choice—usually a freely usable currency—and transfer such currency abroad). The country of issue may not restrict the nonresident's choice to sell or transfer the currency as long as the transfers do not represent international capital movements.

Fourth, Article VIII, Section 2(a) is directed only to payments and transfers for current as opposed to capital international transactions. Restrictions on capital movements can be imposed by a member without the IMF's approval. Article VI, Section 3 provides that

[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....

The meaning of "payments for current transactions" can be found in Article XXX(d):

Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation:

- (1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
- (2) payments due as interest on loans and as net income from other investments;
- (3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and
- (4) moderate remittances for family living expenses.

The Fund may, after consultation with the members concerned, determine whether certain specific transactions are to be considered current transactions or capital transactions.

The definition in the IMF's Articles of current transactions is very broad and encompasses various types of transactions. It does not always coincide with the use of the words "current" and "capital" by economists or balance of payments statisticians. For example, economists sometimes treat amortization of loans and depreciation of direct investment as capital items whereas the Articles treat "payments of moderate amount for amortization of loans or for depreciation of direct investments" as current.

Fifth, Article VIII, Section 2(a) applies to payments and transfers for transactions, not to the transactions themselves. Thus, it does not preclude a member from prohibiting certain imports or other transactions. If, for example, a country prohibits the import of certain luxury items and includes a provision in its exchange control laws prohibiting the use of foreign exchange to pay for prohibited imports, that would not be a restrictive measure within the scope of Article VIII, Section 2(a). Also, a law or regulation that prohibits banks from selling foreign exchange for payments for prohibited imports would not be inconsistent with Article VIII, Section 2(a).

Trade restrictions in the form of quantitative limitations on imports by a member would also not constitute exchange restrictions, though they would have the effect of limiting the overall quantity of payments to nonresidents. Such restrictions do not become exchange restrictions within the meaning of Article VIII, Section 2(a) even if they are imposed for the purpose of conserving foreign exchange. Exchange restrictions are only those measures that interfere with pay-

ments and transfers for current international transactions where the underlying transactions are not restricted.

The only situation so far in which the IMF has equated a restriction on the transaction with a restriction on payments and transfers is that of “normal short-term banking and credit facilities.” In the IMF’s view, since these facilities are so intimately connected with the financing of payments for current international transactions, such as trade, a restriction limiting the availability of these facilities, if they existed, amounts to a restriction on payments, and thus such measures are subject to IMF approval under Article VIII, Section 2(a).

Sixth, Article VIII, Section 2(a) is directed only to the making, as opposed to the receipt, of payments and transfers. The obligation is on the member whose traders are on the paying side as distinguished from the member whose traders are on the receiving side. Thus, a member may determine the currencies in which its traders must receive payments and, for example, require that they be paid in a certain specific foreign currency to the exclusion of all others. A member may also impose a surrender or a repatriation requirement on the foreign currencies that its residents acquire in the course of engaging in international transactions.

Seventh, Article VIII, Section 2(a) is directed at restrictions that are imposed by a member, that is, by the government or a governmental agency of the member, such as the central bank. Exchange restrictions that do not result from governmental acts are not subject to the IMF’s jurisdiction because IMF members are not responsible for them. Thus, for instance, the nonpayment of a debt by an insolvent debtor, or a debtor whose assets have been attached by judicial order at the request of a creditor, or a debtor that, for whatever reason, does not pay a current obligation to a nonresident, would not be an exchange restriction.

The imposition of a restriction by a member may take the form of a law or regulation, but a restriction may also arise from the administrative practice of a member even in the absence of an express regulation. Thus, administrative practices that result in undue delays in the availability or use of foreign exchange for the making of payments and transfers for current international transactions are regarded by the IMF as restrictions within the meaning of Article VIII, Section 2(a).

### ***The IMF's Criterion for Determining the Existence of a Restriction***

In order to clarify the meaning of Article VIII, Section 2(a), the Executive Board of the IMF has decided that “[t]he guiding principle in ascertaining whether a measure is a restriction on payments and transfers for current transactions under Article VIII, Section 2, is whether it involves a direct governmental limitation on the availability or use of exchange as such.”<sup>2</sup> This test involves an examination of all aspects of the exchange measure in question, namely the text of the relevant regulation and its implementation. The application of this test has made it clear that certain types of exchange measures imposed by IMF members that could be viewed by traders as restrictive do not constitute exchange restrictions within the meaning of Article VIII because they do not constitute a limitation on the use or availability of foreign exchange for the making of payments and transfers. For example, a government may insist that payments and/or transfers be made by a particular means of payment or through particular channels without creating restrictions. Thus, when a member prohibited the use by its residents of credit cards abroad, the measure was not considered restrictive by the IMF because other means of payment, such as banknotes and traveler’s checks were available. Registration or licensing used to monitor, rather than to restrict, payments also falls into the above category. Verification requirements such as a requirement to submit documentary evidence that a payment is bona fide also do not constitute exchange restrictions, unless the process results in undue delays.

Finally, it should be noted that the above-mentioned test applies irrespective of the motivation of the restriction. Thus, exchange restrictions that are imposed not for balance of payments reasons, but for security reasons, are nevertheless inconsistent with the obligations of members under the Articles, unless they are approved by the organization.

### *The Concept of Multiple Currency Practice*

Under Article VIII, Section 3, IMF members are prohibited from engaging in any discriminatory arrangement or multiple currency practices without the approval of the organization. That provision leaves to the IMF to define a multiple currency practice. The IMF's policy on multiple currency practices is set out in a Decision of the Executive Board.<sup>3</sup> According to this policy, “[a]ction by a member or its fiscal agencies that of itself gives rise to a spread of more than 2 percent between buying and selling rates for spot exchange transactions between the member's currency and any other member's currency would be considered a multiple currency practice and would require the prior approval of the IMF.”

It must be said from the outset that this policy has been interpreted to apply to any system of multiple rates where an official action is involved, even if it is not giving rise to differences of more than 2 percent at the time it is introduced, if there is no mechanism in place that will prevent such spread from arising. This is because, first, under the IMF's Articles, members are required to seek the prior approval of the IMF, that is, seek approval before introducing measures inconsistent with their undertakings under them, and second, the jurisdiction of the IMF is limited to the approval of measures that are inconsistent with those provisions.

The policy on multiple currency practices is based on a set of basic principles that are essential for determining the existence of a multiple currency practice. Thus, for a multiple currency practice to exist, the following three criteria must be satisfied:

- The multiple currency practice results from an official action by a member or one of its fiscal agencies, which could take the form of an exchange control measure but could also consist of any form of governmental influence, guidance, or direction. Official action could emanate from any part of the member's government, and particularly its various entities with responsibilities on financial or exchange matters.
- The official action must be directly related to an exchange transaction. An exchange transaction is defined as the “exchange of one currency for another” or the “purchase and sale of one cur-

rency in return for another,” the term “currency” being understood as means of payment.

- It must give rise to a multiplicity of effective rates.

Multiplicity refers to the existence of more than one effective rate of exchange. Multiple rates are to be found in differences between a buying and a selling rate, between buying rates or between selling rates that could result in spreads of more than 2 percent. Effective rate means the “imputed rate of exchange resulting from all of the pecuniary elements of the exchange transactions” and it includes “certain costs or subsidies that may be so closely connected with exchange transactions that they must be considered part of the effective rate” if these costs or subsidies are imposed by the authorities.

In order to determine whether charges or subsidies resulting from governmental action are part of the effective rate, it is necessary to determine whether they are directly related to exchange transactions. This determination depends on the facts of each case, but it is necessary to consider the nature of the measure, its effects, and the procedures followed for applying it.

Multiple currency practices are also generally considered to be exchange restrictions because, in most cases, they affect the making of payments for current international transactions and are, therefore, subject to IMF approval under Article VIII, Sections 2(a) and 3.<sup>4</sup> For example, multiple currency practices arising from the existence of an officially managed exchange guarantee scheme for the benefit of only certain categories of traders constitutes a limitation on access to a preferential rate of exchange for those traders that may not benefit from that rate.

### **Types of Exchange Measures Giving Rise to Exchange Restrictions or Multiple Currency Practices**

Set forth below are examples of exchange measures that have been found by the IMF, under certain circumstances, to give rise to exchange restrictions or multiple currency practices, or both, and are subject to approval under Article VIII.

## **Exchange Measures That Give Rise to Exchange Restrictions**

### ***Restrictions on Certain Invisible Transactions***

The imposition of limits by a member on the provision of foreign exchange for payments for certain current international transactions (e.g., in the form of basic allocations for tourist or business travel abroad, education, family living expenses, or payment of insurance premiums) constitutes a limitation on the availability of foreign exchange for current international payments and, therefore, a restriction subject to approval under Article VIII, Section 2(a).

A restriction also arises if there are no basic allowances for certain transactions and the authorities approve requests for foreign exchange for those transactions on a discretionary basis. However, if the limits are only indicative (i.e., if banks are authorized to automatically provide foreign exchange for all transactions within the limits and the authorities approve all requests for foreign exchange transactions beyond the limits upon establishing their bona fide character, or for transactions for which there are no basic allocations once their bona fide character is established) and the public is made aware of such a policy, there is no restriction. It is important that the public is made aware of the policy through some manner of publicity; otherwise, the mere existence of limits will have a chilling effect and thus be restrictive in fact.

### ***Restrictions on the Transferability of Investment Income by Nonresidents***

Members may not restrict the right of nonresidents to convert and transfer proceeds of current international transactions. Thus, any limits on remittances of profits, dividends, or interest (investment income), whether stipulated in terms of time (e.g., repatriation of investment income would not be allowed for a certain number of years after the commencement of production), or amount (e.g., repatriation limited to a certain percentage of the profits made), or a combination of both, would be contrary to Article VIII, Section 2(a). For instance, a dividend-balancing requirement under which certain companies were not allowed, for a certain period of time following the commencement of production, to transfer to their nonresident investors' dividends in excess of the amount of the foreign exchange earnings of

the companies from exports, would be inconsistent with Article VIII, Section 2(a).

### ***Foreign Exchange Budget Allocation***

If a foreign exchange budget is used to determine the availability of foreign exchange for authorized imports rather than to determine the amount of imports that will be permitted during a particular period of time (e.g., during one year), it could give rise to an exchange restriction. For example, this would be the case if, by means of an exchange budget, a member determines the amount of foreign exchange to be available under each heading of national expenditure for imports of goods and services. That would also be the case if a member establishes a foreign exchange budget in the form of exchange quotas for certain categories of importers. These measures constitute exchange restrictions because their necessary consequence is that the availability or use of exchange will be confined to the allocation, and there will be no authorization to use exchange beyond the particular allocation.

### ***External Payments Arrears***

Undue delays in the availability or use of foreign exchange for current international transactions that result from a governmental limitation also give rise to payments arrears and are payments restrictions under Article VIII, Section 2(a) and Article XIV, Section 2 of the IMF's Articles.<sup>5</sup> Thus, although external payments arrears are not themselves a breach of obligations under the Articles, their existence may be the manifestation of an underlying exchange restriction. In that case, the arrears are said to evidence a restriction.

External payments arrears evidence a restriction on the making of payments or transfers for current international transactions when the arrears are owed by private entities or public entities that do not form part of the budgetary process of the government and arise from a governmental limitation on, or interference with, the availability of foreign exchange at the time a payment for a current international transaction falls due, or with the timely transfer of the proceeds of such transactions. They do not evidence restrictions when they are owed by the government itself or by entities that form part of the budgetary process of the government; in these cases, external payments arrears



are treated as government defaults. The rationale for this position is that a government could not be properly regarded as imposing an exchange restriction on itself. External payments arrears do not evidence exchange restrictions when they have arisen because the debtor either lacks the domestic resources necessary to purchase the foreign exchange or refuses to make the payments as they fall due.

Although government defaults are not regarded by the IMF as exchange restrictions, an exchange restriction may still arise if a government, rather than not paying its debt to its foreign creditors, agrees to pay them on accounts in its own territory but then blocks the transfer of the balances from these accounts. This would not be a case of nonpayment but rather one of official limitation on transfers after payment was made. This would be an official limitation on the making of transfers for current international transactions and, therefore, a restriction contrary to Article VIII, Section 2(a).

An exchange restriction evidenced by external payments arrears may be eliminated (1) by removing the limitation on, or interference with, payments and, thereby, allowing the clearance of the arrears by the debtors; or (2) through the conclusion of rescheduling agreements between the government or the debtors themselves and the creditors. It is worth mentioning that arrears owed to Paris Club creditors are not, for purposes of Article VIII, legally rescheduled through the signature of a Paris Club Agreed Minute but only upon the conclusion of all the bilateral rescheduling agreements with creditors.

### ***Import Licensing Procedures***

Import licensing procedures may involve both trade and payments aspects and, thus, may raise the question of when they give rise to exchange restrictions. If no import license is required but an exchange license is needed to make payments for imports, and such license is not automatically granted, there is an exchange restriction. Conversely, if an import license is issued subject to the discretion of the authorities, but as a consequence of the import license, foreign exchange is then automatically made available and payment permitted, then there is no exchange restriction. If an import license is freely granted, but its presentation does not mean that foreign exchange will be made available for payment, then this would be an exchange restriction. A combined import and exchange license is

involved when both the exchange and trade aspects of current transactions are covered by a single authorization. If the measure does not regulate exclusively either the exchange or the trade side of the transaction and is issued on a discretionary basis, it must be regarded as both an exchange restriction and a trade restriction.

### ***“Own Fund” Systems***

Under many of these systems, importers are required to use their own foreign exchange earnings to pay for certain imports and are generally granted import licenses on that condition. Such schemes have generally not been regarded as giving rise to exchange restrictions, unless it is established that importers that are granted import licenses would not be provided access to foreign exchange should they become unable to pay because of insufficient “own funds.” The restriction arises because the authorities would be limiting the availability of foreign exchange to make payments for imports that have been authorized.

### **Exchange Measures That Give Rise to Multiple Currency Practices**

#### ***Different Rates for Different Transactions***

A typical multiple currency practice may occur when the central bank sets different exchange rates that apply to different categories of transactions (e.g., official transactions, commercial transactions, tourist transactions, etc.), which result in spreads of more than 2 percent between these rates.

#### ***Exchange Taxes***

A tax or subsidy payable on exchange transactions, or on the purchase or sale of a foreign currency, may be related enough to the exchange of currencies to be considered part of the effective exchange rate and, therefore, give rise to a multiple currency practice. If a tax is withheld from all payments to all nonresidents, it has been considered to be an application of the income tax, but if the liability for the tax is incurred only if the amount is to be remitted abroad (for instance, if the tax is collected at the time the exchange is purchased to make the

payment), the tax has been considered as part of the effective exchange rate and, thus, as giving rise to a multiple currency practice.

### ***Exchange Guarantees***

Exchange guarantees provided by a member to cover the exchange risks of its fiscal agencies are analyzed as a provision by the member of a subsidized exchange rate. Under many of these systems, compensation for exchange losses is not part of the nominal exchange rate applied to the purchase of foreign exchange by the beneficiary of the guarantee, but it is part of the effective exchange rate as defined by the IMF because the benefit of the coverage of exchange risk flows directly from exchange losses that are assumed by the guarantor with no or inadequate compensation of the risk involved and, thus, from the exchange transaction in which these losses are realized.

A system for covering exchange risks managed by a member or its fiscal agencies does not give rise to a multiple currency practice if it is self-financed, that is, if the premiums paid by the beneficiaries of the system are sufficient to cover the exchange risks. In such a case, the system is unlikely to need official subsidies to meet its liabilities. The self-financing character of the system is evaluated in advance, that is, when the system is set up and the liabilities are incurred (and not when compensation is paid). It is then that it must be determined whether a multiple currency practice exists. However, regular assessments need to take place so as to ensure that the system remains self-financed over time so that a multiple currency would not arise.

### ***Broken Cross Rates***

Broken cross rates are a type of multiple currency practice that arise from “[a]ction by a member or its fiscal agencies which results in midpoint spot exchange rates of other members’ currencies against its own currency in a relationship which differs by more than 1 percent from the midpoint spot exchange rates for these currencies in their principal markets. If the differentials of more than 1 percent in these cross rates persist for more than a week, the resulting multiple currency practice would become subject to approval of the Fund under Article VIII, Section 3.”<sup>6</sup>

Let us consider Country X that establishes fixed rates of exchange between its currency C and, for example, the U.S. dollar and the euro:  $C = \text{US\$}1$  and  $C = \text{€}2$ . The cross rate between the dollar and the euro in Country X in this example would be that one dollar equals two euros. If this implicit rate of exchange between the U.S. dollar and the euro deviates for more than a week by more than 1 percent from the rates between these two currencies in their principal markets, this would be regarded as giving rise to a multiple currency practice subject to IMF approval, unless there is a mechanism in place to ensure that such deviations would last for less than a week.

### ***Dual or Multiple Exchange Markets***

If the authorities establish separate exchange markets and the co-existence of these markets results in spreads of more than 2 percent between the rates in the different markets, or if such a spread arises at any time due to the lack of a mechanism to avoid spreads of more than 2 percent, then a multiple currency practice subject to IMF approval arises if current transactions are to take place in both markets. However, if one of the markets is relegated to only capital transactions, the existence of the measure will be identified but it will not be characterized as a multiple currency practice requiring the approval of the IMF. Executive Directors, representing a majority of the total voting power in the organization, considering that members are free to impose capital restrictions in accordance with Article VI, Section 3, have not been persuaded by the position of the IMF staff that multiple currency practices on capital transactions are also subject to the obligation of Article VIII, Section 3.

A multiple currency practice would also arise if the authorities, having established an official market, were to allow the existence of a free market without establishing any mechanism to ensure that spreads of more than 2 percent would not arise between the rates in these markets and if not all current transactions have access to the official market.

## **Exchange Measures That May Give Rise to Restrictions and Multiple Currency Practices**

### ***Bilateral Payments Arrangements***

Historically, bilateral payments arrangements (BPAs) have taken a variety of forms, and each arrangement must be examined closely to determine whether or not it contains features that would be subject to IMF approval under Article VIII, Sections 2(a) or 3. BPAs may give rise to restrictions on transfers as well as to multiple currency practices.

**Restrictions on Transfers.** An exchange restriction arises whenever a member restricts the right of a nonresident to transfer abroad balances of currency that the nonresident has recently acquired as a result of current international transactions. This is the case when the nonresident in question is either another member of the IMF or its central bank. Under most BPAs, partner banks accumulate balances of currency as residents of the partner countries make payments for current international transactions through the arrangement, and amounts are credited or debited from the accounts of the partner banks. In many cases, a partner bank will not be permitted to freely convert and transfer the net credit balance that it holds against another partner bank; rather, this amount will be available only for payments between the parties. Settlement of a credit balance will take place only upon the expiration of the period of settlement specified in the arrangement. The IMF has determined that these official arrangements give rise to exchange restrictions under Article VIII, Section 2(a) if balances are not settled, at a minimum, every three months because such balances would otherwise be unavailable to make payments and transfers for current international transactions.

**Multiple Currency Practices.** BPAs may also give rise to multiple currency practices when the arrangements make use of “special” exchange rates. For the spreads between these rates and other rates in a member’s territory to be taken into account, they need to be connected to actual exchange transactions. Exchange transactions under a bilateral payments arrangement may be identified at the level of the residents making use of the arrangement (when an importer pays its central bank in its local currency and in turn the exporter receives

payments in its local currency from its central bank) and at the level of the partner banks (which may be at the time of crediting of the account between partner banks and/or at the time of settlement of official balances between partner banks).

Thus, a multiple currency practice will arise from a BPA that provides that exchange transactions under the arrangement will be conducted at “special” exchange rates, which differ by more than 2 percent from those prevailing in the markets. A BPA would also give rise to a multiple currency practice if it specifies rates that are consistent with market rates at the commencement of the arrangement’s operation but does not provide for such rates to be subsequently adjusted during the arrangement’s operation to ensure that they will not, at any time, differ by more than 2 percent from the rates prevailing in the market.

### ***Foreign Exchange Auctions***

Foreign exchange auction systems have often been found to give rise to exchange restrictions and to multiple currency practices. The typical restrictive feature of these systems is that the authorities limit the volume of foreign exchange made available to residents for the making of payments and transfers for current international transactions. Thus, an exchange restriction will arise when the auction is the sole source of foreign exchange and the amount of foreign exchange made available at auctions is insufficient to meet the demand for foreign exchange to make current payments. If the authorities allocate foreign exchange outside the auction for certain payments while the exchange made available at the auction is insufficient to meet the demand, an exchange restriction would also arise.

If the allocation of foreign exchange outside the auction is made at a different exchange rate than the auction rate and the two rates may differ by more than 2 percent, the system gives rise to a multiple currency practice, unless there is a mechanism in place that prevents such spreads from arising. An official Dutch auction system also gives rise to multiple currency practices if the rates at which successful bidders are sold foreign exchange at the same auction could differ by more than 2 percent.

### ***Import Deposit Requirements***

Advance import deposit requirements and cash margin requirements for letters of credit inherently give rise to exchange restrictions, because the basic feature of such schemes, namely that the payer is required to block resources for a period of time as a condition for making a payment for a current international transaction, constitutes a direct limitation on payments for imports. No exchange restriction would be involved if the advance deposit or cash margin applied only to one means of payment (e.g., payment by check) while other normal means of payments for imports were available and remained unrestricted. No exchange restriction would arise if the deposit were a condition for the issuance of an import license, rather than a condition for the payment of the import (unless, of course, having the import license is a precondition to making payments in their connection).

Another case is the imposition of a deposit requirement on tourist exchange requests. Such a measure has been found to be restrictive because it imposes a significant precondition (and usually an added cost) on the availability of foreign exchange, and amounts to a governmental limitation on the availability of foreign exchange.

If the government requires an import deposit to be made before a letter of credit is opened or foreign exchange purchased, the measure is directly connected with the exchange transaction and the cost is considered to be part of the effective exchange rate. Thus, import deposit requirements have been found to give rise to multiple currency practices when the rate of interest, if any, paid on the deposits was lower than the prevailing market interest rate. The absence of interest or the existence of an interest rate below the market rate is analyzed as an additional cost of the exchange transaction.

### **Legal Effects of Approval and Nonapproval of Exchange Restrictions by the IMF**

#### ***General Considerations***

Pursuant to Article VIII, Section 2(a), the requirement of approval by the IMF does not apply to exchange restrictions maintained by a member in accordance with Article XIV, Section 2. Article XIV,

Section 2 authorizes a member to maintain and adapt to changing circumstances its exchange restrictions that were already in effect when it became an IMF member but does not allow it to impose new restrictions. Thus, the benefits deriving to a member from the transitional arrangements are (1) the right to maintain and adapt, without requiring the approval of the IMF, the restrictions in effect on the date it became a member; and (2) an understanding that the restrictions so maintained or adapted are in accordance with the member's obligations under the Articles. The criterion applied to determine whether the modification of an Article XIV restriction is an adaptation under Article XIV or an imposition under Article VIII is whether the modification restricts an activity that was previously unrestricted (in which case it would be an imposition) or whether it merely affects the level of the restriction (in which case it would be an adaptation). The criterion is, therefore, whether the change in the restriction is one of degree or one of nature.

Approval is normally granted by the IMF by a formal decision, provided that the organization is satisfied that the restrictions are imposed for balance-of-payments reasons and are not discriminatory and that their use will be temporary while the member is seeking to eliminate the need for them. The IMF follows, however, a different procedure for the approval of restrictions imposed for security reasons. In this connection, Decision No. 144-(52/51), adopted August 14, 1952, provides that restrictions notified to the IMF pursuant to that decision are approved for purposes of Article VIII, Section 2(a), unless the IMF informs the member within 30 days after receiving the notice that it is not satisfied that such restrictions are imposed solely to preserve national or international security.

### ***Effects of IMF Approval on the Relations Between the IMF and the Member Imposing the Restrictions***

Because Article VIII, Section 2(a) prohibits the imposition of exchange restrictions without the IMF's approval, exchange restrictions that are not approved by the IMF are inconsistent with the Articles and approved restrictions are consistent with the Articles. The main consequence of nonapproval of exchange restrictions by the IMF is that the member is in breach of an obligation assumed by it under the Articles, and the IMF may, under the Articles, take certain actions regarding that member. Such actions include the issuance of a



report by the Managing Director to the Executive Board or a complaint by the Managing Director or other members that a member is not complying with its obligations regarding exchange controls, discriminatory currency arrangements, or multiple currency practices; a declaration of ineligibility to use the general resources of the organization, which causes the suspension of the member's entitlement to use the IMF's general resources; and a suspension of the member's voting and related rights, which may be followed by the compulsory withdrawal of the member.

It should be noted that the IMF may authorize the use of its general resources by a member imposing or maintaining exchange restrictions, even when they are imposed without the approval of the IMF. However, it may also adopt policies on the use of its general resources, or decisions on individual requests for purchases, denying, or limiting access to its general resources to members that impose exchange restrictions that the IMF is not prepared to approve, or that maintain restrictions that are inconsistent with the IMF's purposes. In addition, when examining a member's request for use of its general resources, the organization must examine the member's exchange restrictions (existing or contemplated), taking into account the purpose, under the Articles, of avoidance or elimination of exchange restrictions.

### ***Recognition of Exchange Control Regulations by Foreign Courts Under the IMF's Articles***

Article VIII, Section 2(b) imposes an obligation on member countries with respect to exchange control regulations of other member countries: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member." The meaning of this provision has been partially clarified by a Decision of the IMF.<sup>7</sup> Four points of this decision are particularly important.

- Article VIII, Section 2(b) applies even when the exchange control regulations are not part of the *lex contractus*; it does not give competence to the *lex monetae* (the law of the member whose currency is involved) as *lex contractus*; the provision is not a rule of conflict, but a substantive rule of private international law.

- Public policy (*ordre public*) cannot be invoked against the recognition of another member's exchange control regulations if they are consistent with the IMF's Articles.
- Unenforceability means that the performance of the contract cannot be decreed, and damages for nonperformance cannot be awarded, by the judicial or administrative authorities of other member countries, but that the contract may remain valid, and there is no prohibition on voluntary performance by the parties. From the reference to the authorities of other member countries, it follows that the authorities of the member enacting the regulation, as well as international and arbitral tribunals, are not subject to this provision.
- The IMF stands ready to advise whether a particular exchange control regulation is consistent with the Articles.

The applicability of Article VIII, Section 2(b) is predicated on the consistency with the Articles of the exchange control regulations that have been infringed by the contract. For those regulations that consist of restrictions on payments and transfers for current international transactions, consistency requires that they be maintained under Article XIV, Section 2 or approved by the IMF under Article VIII, Section 2(a). Thus, when the IMF approves a member's exchange restrictions under Article VIII, Section 2(a), a necessary effect is the application of Article VIII, Section 2(b) to exchange contracts involving the member's currency that are contrary to these restrictions. Capital restrictions that do not restrict payments for current transactions or do not unduly delay transfers of funds in settlement of commitments are consistent with the Articles and thus covered by the provision.

Article VIII, Section 2(b) raises complex issues of interpretation of its main concepts. The concept of "exchange contract" has been interpreted differently by the courts of IMF members. There are at least three different interpretations: (1) a broad interpretation (followed by French and German courts) is that exchange contracts are any contracts that affect a country's exchange reserves; (2) a narrow interpretation (followed by U.K. and U.S. courts) confines exchange contracts to contracts for the exchange of the currency of a country against the currency of another; and (3) an intermediate

interpretation (proposed by the IMF staff) defines an exchange contract as a contract providing either for payment or transfer of exchange or for an international payment or transfer (i.e., a payment between a resident and a nonresident, or a transfer of funds from one country to another).

Exchange control regulations are defined by the IMF staff as regulations pertaining to the acquisition, holding, or use of foreign exchange as such, or to the use of domestic or foreign currency in international payments or transfers as such. The meaning of “involving the currency” depends on the interpretation given to the term “exchange contract.” For those who define it as a contract for the exchange of currencies, a member’s currency is involved if it is one of the currencies that are exchanged. In contrast, for those who view exchange contracts as contracts affecting the member’s exchange resources, the phrase “exchange contracts which involve the currency of any member” refers to contracts affecting a member’s balance of payments or exchange resources. This interpretation raises the question of the appropriate criterion to be used to determine when a member’s balance of payments is affected. The position of the IMF staff is that a member’s currency is involved by a contract when either the performance of the contract is to be made from assets located in the member’s territory or a resident of the member is a party to the contract.

The date as of which the conditions of (1) involvement of a member’s currency by a contract, (2) contrariness of the contract to a member’s exchange control regulations, and (3) consistency of the regulations with the IMF’s Articles must be assessed is, in the view of the IMF’s staff, the date on which performance of the contract is sought.

The sanction of unenforceability prescribed in Article VIII, Section 2(b) means that the judicial and administrative authorities of members should not lend their assistance to any party seeking performance of exchange contracts of the type described in this provision or seeking damages for the nonperformance of the same.

As already mentioned, one of the conditions for the applicability of Article VIII, Section 2(b) is that the exchange control regulations to which the contract is contrary be maintained or imposed consis-

tently with the Articles. It follows that when a member imposes exchange restrictions that, while subject to the approval of the IMF, are not approved, other members are under no obligation to give any effect to these restrictions. Moreover, since the IMF's Articles recognize the right of members to impose capital restrictions, such restrictions, if maintained by members, are consistent with the IMF's Articles unless they also limit current payments. However, more recently, the German highest court has concluded that only exchange measures subject to the IMF's approval jurisdiction, or maintained by members in accordance with the transitional provisions of Article XIV, are covered by the provisions of Article VIII, Section 2(b). The main basis for its conclusion is the title of Article VIII, Section 2, which reads, "Avoidance of restriction on current payments."

## Notes

<sup>1</sup> IMF, *Articles of Agreement of the International Monetary Fund*, Article I(i), (iii), and (iv).

<sup>2</sup> Decision No. 1034-(60/27), June 1, 1960, reprinted in IMF, *Selected Decisions and Selected Documents of the International Monetary Fund*, Twenty-Eighth Issue (Washington: IMF, 2004) [hereinafter *Selected Decisions*], at 509–11.

<sup>3</sup> Decision No. 6790-(81/43), as amended, March 20, 1981 [hereinafter Decision No. 6790-(81/43)], reprinted in *Selected Decisions*, *supra* note 2, at 523–25.

<sup>4</sup> For instance, a multiple currency practice arising from a more favorable rate on sales of certain foreign exchange receipts would not give rise to an exchange restriction under Article VIII, Section 2(a), since the latter applies only to the making of payments and transfers for current international transactions and not to receipts of such payments.

<sup>5</sup> The treatment of arrears by the IMF is found in Decision No. 3153-(70/95), October 26, 1970, *Selected Decisions*, *supra* note 2, at 511–12.

<sup>6</sup> Decision No. 6790-(81/43), *supra* note 3, at 524.

<sup>7</sup> Decision No. 446-4, June 10, 1949, *Selected Decisions*, *supra* note 2, at 501–502.

**The Obligation of Members to Provide  
Information to the International  
Monetary Fund Under Article VIII,  
Section 5: Recent Developments**

ROSS LECKOW

For the International Monetary Fund (IMF), information is of vital importance. To fulfill its mandate under the Articles of Agreement, the IMF relies upon its member countries to provide it with information on their economies and policies. The Articles of Agreement set out in Article VIII, Section 5 a detailed legal framework for the reporting of information to the IMF by members.<sup>1</sup> The IMF has sought to ensure that this legal framework will continue to be effective as the global economy and the IMF's information needs gradually evolve. It was for this reason that the IMF's Executive Board, in January 2004, adopted a decision that, in many ways, strengthens the effectiveness of Article VIII, Section 5.

This chapter examines the legal framework for the reporting of information to the IMF by members under Article VIII, Section 5 and the IMF's recent efforts to strengthen the effectiveness of this provision. It first explains why information is important to the IMF before discussing the need for a legal framework governing the provision of information to the IMF. It then reviews the basic features of members' obligations under Article VIII, Section 5 and the consequences for a member of a breach of obligation under that provision. It ends with a brief conclusion.

**The Importance of Information**

Why is information important to the IMF? The receipt of accurate information is essential for everything the IMF does—including its two principal activities: crisis prevention and crisis resolution.

The IMF's principal mechanism for crisis prevention is surveillance under Article IV of the IMF's Articles. Through the

Article IV consultation process, the IMF engages in firm surveillance over members' exchange rate policies and, more generally, monitors their economic and financial policies.<sup>2</sup> When the IMF believes that a country's policies may lead to a balance of payments crisis, it seeks to persuade the authorities of that country to change course before it is too late.

The receipt by the IMF of timely and accurate information on the state of a country's economy is key to the success of this process. Without such information, the organization may not identify a looming crisis or may not advise on appropriate policies. There has been more than one case where a lack of such information has hampered the IMF in its efforts to prevent the occurrence of a crisis.<sup>3</sup>

Similar problems can arise when the IMF is involved in crisis resolution. The IMF's principal mechanism for the resolution of a balance of payments crisis in a country is the provision of financial assistance to the authorities of that country in support of a program of economic reform that they implement.<sup>4</sup>

Timely, accurate data are essential for the IMF to work effectively with the authorities in designing an economic reform program and in monitoring its implementation. In the absence of such data, the design of the program may be flawed. Moreover, the disbursement of resources from the IMF is, in most cases, conditional upon the member meeting key economic targets drawn from the program.<sup>5</sup> The provision of inaccurate data by the member may lead the IMF to disburse resources that the member was not entitled to receive. Over the past few years, there have been several high-profile cases in which countries receiving financial assistance have "misreported" economic data to the IMF.<sup>6</sup>

### **The Need for a Legal Framework for Reporting Information**

Given the importance of information, how can the IMF most effectively obtain it? In principle, there are at least two possible approaches: (1) relying on the voluntary cooperation of members, and (2) establishing a legal obligation to report information. Each is examined below.

## **Voluntary Cooperation**

Some have argued that the IMF does not need to legally require its members to provide information. The IMF should be able to rely solely upon the voluntary cooperation of members to obtain whatever it needs. This approach is based on the strong relationship of trust that the IMF enjoys with each of its members. It recognizes that members have an interest in ensuring the effectiveness of the organization as they are its principal beneficiaries. It also rests upon the belief that economic conditions and the information needs of the IMF may change too quickly to be incorporated into a legal obligation.

These arguments, although appealing, are not entirely convincing. There have been cases when the IMF's relationship of trust with a member has broken down. A member may be reluctant to reveal the true state of its economy to the IMF. The authorities of a country on the verge of a crisis may be in a state of denial or may seek to solve the problem on their own.

## **A Legal Obligation to Report**

Reliance upon a legal obligation to report information offers advantages that voluntary cooperation cannot provide. It ensures greater uniformity of treatment and certainty as to what members are required to report.<sup>7</sup> It also provides the IMF with effective tools with which to address cases in which members either refuse to provide data or report inaccurate data.

In determining how to most effectively obtain information from its members, the IMF has employed both approaches. The IMF has, to a large extent, relied upon voluntary cooperation. This approach has generally worked well. At the same time, the drafters of the IMF's Articles recognized that there will be cases in which voluntary cooperation will not be enough. It is for this reason that they incorporated into the IMF's Articles an explicit obligation—set out in Article VIII, Section 5—for members to report certain types of information to the IMF. It is an original provision and has not been amended since the organization's establishment.



## **The Principal Features of Article VIII, Section 5**

Article VIII, Section 5 sets out a comprehensive legal framework for the reporting of information by members.<sup>8</sup> It establishes an obligation on the part of members to report specified information to the IMF in certain circumstances. The obligation to report information applies to all IMF members. Moreover, the information covered by this provision can be required of members for the purposes of any of the IMF's activities, including surveillance and financial assistance.<sup>9</sup>

In deciding how to require information from members, the drafters of Article VIII, Section 5 had to choose between two alternatives. Under one approach, they could have specified in the provision all of the categories of information that members would be required to report. This approach would have provided members with considerable certainty. However, it would not have allowed the IMF to adjust reporting requirements as conditions evolve. Every time the IMF needed to add a new category of information, it would have been necessary to amend the Articles of Agreement.

Under an alternative approach, the drafters could have avoided spelling out any specific categories of information in the Articles. Rather, they could have given the IMF the power to decide what information members would be required to report. This approach would have given the IMF greater flexibility to adapt information requirements to changing circumstances. However, it would have been very open-ended. Members would have been provided with relatively little certainty as to what would be required of them.

The drafters of Article VIII, Section 5 chose a combination of these two approaches. The provision sets out a list of information that, as a minimum, must be reported by all members. Members are required to report this information whether or not it is requested by the IMF.<sup>10</sup> At the same time, Article VIII, Section 5(a) empowers the IMF to require additional information from members whenever necessary for the organization's activities.<sup>11</sup> In this manner, the provision seeks to draw an appropriate balance between certainty and flexibility.

With respect to the IMF's power to require additional information, three points should be noted. First, under Article VIII, Section 5, it is the Executive Board of the IMF that may require such information; IMF staff and management have no power to legally require information for members.<sup>12</sup> Second, the IMF may only require additional information if it is "necessary" for the IMF's activities; it is the Executive Board of the IMF that decides whether the information is necessary.<sup>13</sup> Third, for the Executive Board to require such information under Article VIII, Section 5, the Board must adopt a decision by a majority of votes cast calling upon the member to provide the information.<sup>14</sup>

There are two basic types of decisions that the Board can adopt for these purposes. It can adopt a decision of general applicability that applies to all IMF members and requires all of them to report particular categories of information. Alternatively, it can adopt a decision that applies to a specific member and only requires that member to provide information. Such a decision can also apply to a specific group of members.

The IMF has made use of this power to require accurate reporting for the purposes of both financial assistance and surveillance. In the context of financial assistance, the IMF has required the accurate reporting of information necessary to assess observance by members of performance criteria under Stand-By and Extended Arrangements in the General Resources Account. Every Stand-By and Extended Arrangement is a decision of the Executive Board. These arrangements typically establish performance criteria that the member must meet before a disbursement will be made. The information that members report to the IMF to assess observance of a performance criterion is subject to the requirements of Article VIII, Section 5.<sup>15</sup> When members report such information to the IMF, they are under a legal obligation to ensure it is accurate.<sup>16</sup>

The IMF has also begun to adopt decisions requiring the production of information for the principal purpose of surveillance. Over the past few years, there has been a growing recognition that the information specifically required of members under Article VIII, Section 5 fell short of what was needed to conduct effective surveillance. The only data that members were legally required to report for this purpose was the information explicitly listed in Article

VIII, Section 5.<sup>17</sup> This list reflects the realities of the global economy of 1944. It is out-dated. It emphasizes issues that are relatively unimportant today (e.g., a member's gold holdings) and ignores other factors that are now crucial (e.g., the member's fiscal position).<sup>18</sup>

The Executive Board therefore decided, in January 2004, to adopt a decision to require all members to report a list of additional information deemed essential for surveillance.<sup>19</sup> Most of the items on this expanded list derive from the IMF's "core list of statistical indicators" for effective surveillance.<sup>20</sup> This expanded list sets out categories of information that reflect the principal features of the global economy of the twenty-first century. The Board agreed to review the appropriateness of the information on the list no later than December 31, 2007.<sup>21</sup> It also reserved the right to require any additional information necessary for surveillance, where warranted, from individual members.

In putting in place this expanded framework, the IMF took great care to ensure that it would not subject members to an unreasonable burden. Most members have voluntarily reported this information for some time. Moreover, the Board decided that members would not have to begin reporting this information immediately. The obligation to report this expanded list would only apply to information whose relevant period began after December 31, 2004.<sup>22</sup> The purpose of this "grace period" was to give members sufficient time to make any necessary adjustments to their statistical reporting systems.

There is one more important point that should be noted with respect to the original list in Article VIII, Section 5 and the additional list. For the original list, nothing was specified with respect to the periodicity or timeliness with which the information must be provided.<sup>23</sup> The drafters of the provision wanted the information to be provided on a continuous basis and in as accurate and up-to-date a form as possible. A similar approach has been taken for the additional list. This approach is particularly important in the context of surveillance, which is a continuous process. Under Article IV, the IMF continuously monitors developments in its member countries and may raise issues of concern with a member at any time.

With respect to Article VIII, Section 5, it is not only members that are subject to obligations. The IMF is under an obligation as

well: it must keep confidential any information that the member reports. While such information must be made available to the IMF's Executive Board, it cannot be made public without the member's consent. This is particularly important with respect to market-sensitive information.

The obligation of members to report information under Article VIII, Section 5 is not absolute. It is subject to two important limitations. First, members cannot be required to report information in such detail that the affairs of individuals or corporations would be disclosed.<sup>24</sup> The IMF is concerned with macroeconomic issues. It should not need information at so specific a level that it would threaten the privacy of individuals or corporations. Second, the obligation of a member to report particular information is qualified by the member's ability or capacity to report such information.<sup>25</sup> The drafters of the IMF's Articles recognized that collecting and reporting economic statistics is a difficult and time-consuming process. This is particularly true for poorer developing countries. It would not be equitable or practical for the IMF to establish a strict reporting obligation with which many of its members could not comply.

It is for this reason that Article VIII, Section 5(b) requires the IMF "to take into consideration the varying ability of members to furnish the data requested." To the extent that a member has failed to accurately report particular information but can demonstrate that it does not have the technical capacity to do so, it will not be held in breach of Article VIII, Section 5.<sup>26</sup>

How does the IMF assess a member's capacity? There are no criteria specified in the Articles for this purpose, and the IMF has not attempted to specify criteria. Rather, the IMF assesses capacity on a case-by-case basis, taking into account a wide range of factors.<sup>27</sup>

In extreme cases, it is relatively easy for the IMF to assess a member's capacity. If a member admits that it has certain information and simply refuses to disclose it to the IMF, it will not be able to claim the capacity defense. In contrast, a country whose infrastructure has been devastated by a natural disaster will clearly not have the capacity to collect and report economic data. The more difficult cases fall in the middle. Here, the IMF engages in a broad-based analysis of the member's circumstances, including the

complexity of the data and the member's level of development. In this analysis, it gives the benefit of any doubt to the member.

A member cannot rely upon a lack of capacity as a defense indefinitely. Article VIII, Section 5(b) requires members "to furnish the information in as detailed and accurate a manner as is practicable and, so far as possible, to avoid mere estimates." Thus, members are required, over time, to improve their statistical reporting systems and to place themselves in a position in which they can accurately report the data the IMF needs.

### **The Consequences of a Breach of Article VIII, Section 5**

Within this legal framework, how can a member breach its obligation to report information under Article VIII, Section 5? Generally, a breach of obligation will arise when a member (1) fails to report certain information at all or in a timely manner, or (2) reports inaccurate information. A member may breach Article VIII, Section 5 even if the authorities of the member did not intend to do so. Intent is not an essential element of the "offense."

There are three reasons for this approach. First, there is nothing in the provision that suggests that a malicious intent is a necessary element of a breach. Second, as a practical matter, it would be difficult for the IMF to obtain the information necessary to determine that such an intent existed. Third, if a malicious intent were an essential element of a breach of Article VIII, Section 5, it would need to be determined whose intent is relevant. Would it be necessary to show that the Prime Minister or the cabinet of the country intended to mislead the IMF or would it be sufficient to show that the deception was the work of a junior statistics officer in the central bank? Rather than looking at the question of intent, the IMF determines whether accurate information has been provided on a timely basis and whether the authorities of the country had the capacity to report such information.

What happens when a member is found in breach of obligation under Article VIII, Section 5? The Executive Board will make a finding of breach of obligation and the member will be subject to the sanctions specified in Article XXVI of the IMF's Articles. While the

Board may impose a sanction under Article XXVI, it is not required to do so.<sup>28</sup>

There are three sanctions specified under Article XXVI: (1) a declaration of ineligibility to use the general resources of the IMF, (2) the suspension of a member's voting and certain related rights in the IMF's decision-making organs, and (3) compulsory withdrawal of the member from the IMF. These sanctions are imposed over time and in order of severity, to the extent that the member remains in breach of obligation.

The sanctions specified in Article XXVI are very severe and may not be appropriate for a breach of Article VIII, Section 5. In the context of Article VIII, Section 5, these sanctions have only been applied once—in 1954, when Czechoslovakia was expelled for the refusal of its government to provide certain information to the IMF.<sup>29</sup> These sanctions do not provide an effective remedy that ensures that the problems encountered with reporting by a member will not be repeated.<sup>30</sup>

In light of these difficulties, the decision adopted by the Executive Board in January 2004 to strengthen the effectiveness of Article VIII, Section 5 put in place a more effective procedural framework designed to address cases involving a breach of Article VIII, Section 5. This new framework seeks to accomplish two objectives. First, it sets out comprehensive procedures which the IMF will follow in cases involving a breach of Article VIII, Section 5. Second, it establishes an approach to remedial action that relies less upon the imposition of sanctions under Article XXVI and more upon efforts to cure a breach and ensure that it will not happen again.<sup>31</sup>

The procedural framework contemplates the IMF taking a series of graduated steps under which the member will be called upon to take specified remedial actions that are designed to ensure accurate and timely reporting in the future.<sup>32</sup> Where appropriate, emphasis will be placed upon technical assistance from the IMF. Only where the IMF determines that the member is not prepared to take the steps necessary to prevent a recurrence of its reporting problems will the sanctions of Article XXVI be considered.

The procedural framework also relies upon peer pressure. Each Board decision taken in the remedial process will be published in an effort to persuade the member to address its underlying problems.<sup>33</sup> The precise wording of the statement issued by the IMF will be calibrated to the circumstances of the particular case.

### **Conclusion**

In conclusion, the provision of timely, accurate information by members is of paramount importance in ensuring the effective operation of the IMF and the international monetary system. Article VIII, Section 5 establishes a strong legal framework for the reporting of information by the organization's members. The IMF's recent efforts to strengthen the effectiveness of Article VIII, Section 5 point to the need for the IMF to continuously review and adjust this framework in response to changes in the IMF's information needs and in the global economy. More fundamentally, the IMF's efforts demonstrate the importance of a legal framework in facilitating international monetary cooperation and in ensuring international financial stability. As an important component in the international legal framework, Article VIII, Section 5 has proven itself as an effective instrument that will help the IMF meet the challenges of the global economy of the twenty-first century.

## Notes

<sup>1</sup> IMF, *Articles of Agreement of the International Monetary Fund*, Article VIII, Section 5 [hereinafter *Articles of Agreement*], <http://www.imf.org/external/pubs/ft/aa/index.htm>.

<sup>2</sup> F. Gianviti, *The International Monetary Fund and External Debt*, in *Recueil des Cours* 209 (1989), at 268.

<sup>3</sup> *Strengthening the Effectiveness of Article VIII, Section 5* (IMF Board Paper, 05/02/03), at 5 [hereinafter *Strengthening the Effectiveness of Article VIII, Section 5*], <http://www.imf.org/external/np/a8/eng/2003/050203.htm>.

<sup>4</sup> R. Edwards, *International Monetary Collaboration* 223 (1985).

<sup>5</sup> Gianviti, *supra* note 2, at 255.

<sup>6</sup> See, e.g., *IMF Finds Ukraine National Bank Misreported International Reserves, Considers Circumstances, and Proposes Measures to Prevent Recurrences* (IMF News Brief No. 00/77, 09/06/00), <http://www.imf.org/external/np/sec/nb/2000/nb0077.htm>.

<sup>7</sup> *IMF Approves Decisions Strengthening the Effectiveness of the Legal Framework for the Provision of Information to the IMF* (Public Information Notice No. 04/10, 02/23/04) [hereinafter *IMF Approves Decisions Strengthening the Effectiveness of the Legal Framework*], <http://www.imf.org/external/np/sec/pn/2004/pn0410.htm>.

<sup>8</sup> *Strengthening the Effectiveness of Article VIII, Section 5*, *supra* note 3, at 8.

<sup>9</sup> *Id.* at 12.

<sup>10</sup> The IMF has no power to delete an item from this list; a deletion may only be made by an amendment of the IMF's Articles. *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> A Board decision is all that is necessary for this purpose. It is not necessary to amend the IMF's Articles by adding to the list set out in Article VIII, Section 5.

<sup>15</sup> *IMF Approves Decisions Strengthening the Effectiveness of the Legal Framework*, *supra* note 7.



<sup>16</sup> The IMF has put in place a separate framework—the “Guidelines on Misreporting”—with which to deal with cases in which members fail to accurately report information associated with the provision of IMF financial assistance. *See, e.g.*, “Misreporting and Noncomplying Purchases in the General Resources Account—Guidelines on Corrective Action,” Decision No. 7842-(84/165), adopted November 16, 1984, as amended, reprinted in *Selected Decisions and Selected Documents of the International Monetary Fund, Twenty-Ninth Issue* (Washington: IMF, 2004) [hereinafter *Selected Decisions*], at 235.

<sup>17</sup> While, generally, most members voluntarily reported the rest of the information needed by the IMF, the IMF effectively had no legal recourse if the member either refused to report such information or reported it inaccurately.

<sup>18</sup> *Strengthening the Effectiveness of Article VIII, Section 5, supra* note 3, at 14.

<sup>19</sup> *IMF Approves Decisions Strengthening the Effectiveness of the Legal Framework, supra* note 7.

<sup>20</sup> *Strengthening the Effectiveness of Article VIII, Section 5, supra* note 3, at 17.

<sup>21</sup> *Strengthening the Effectiveness of Article VIII, Section 5* (Decision No. 13183-(04/10), adopted January 30, 2004) [hereinafter Decision No. 13183-(04/10)], reprinted in IMF, *Selected Decisions*, at 486.

<sup>22</sup> *Id.*

<sup>23</sup> *Strengthening the Effectiveness of Article VIII, Section 5, supra* note 3, at 12.

<sup>24</sup> *Articles of Agreement, supra* note 1, Article VIII, Section 5(b).

<sup>25</sup> *Strengthening the Effectiveness of Article VIII, Section 5, supra* note 3, at 13.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 26.

<sup>29</sup> *Id.* at 25. *See also* J. Gold, *Membership and Nonmembership in the International Monetary Fund* (1974), at 360.

<sup>30</sup> *Strengthening the Effectiveness of Article VIII, Section 5, supra* note 3, at 26.

<sup>31</sup> *Id.* at 30. See also Decision No. 13183-(04/10), *supra* note 21; *IMF Approves Decisions Strengthening the Effectiveness of the Legal Framework*, *supra* note 7.

<sup>32</sup> Decision No. 13183-(04/10), *supra* note 21.

<sup>33</sup> *Id.* at para. 17. See also *IMF Approves Decisions Strengthening the Effectiveness of the Legal Framework*, *supra* note 7.

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A strong and sound financial system provides countries with the foundation for robust economic activity and growth. Financial stability is equally important, particularly given what has been learned from events in the recent past in which the contagious effects of one country's financial instability adversely affected others. Naturally, financial stability may be said to be found in the absence of systemic financial crises that threaten macroeconomic stability; however, financial difficulties of individual institutions may still arise from time to time, but, when contained, should not be viewed as posing an inescapable threat to an otherwise stable financial system.

As the international organization responsible for surveillance over member countries' financial sectors and many aspects of the international financial system, the International Monetary Fund (IMF) has a special role to play in safeguarding macroeconomic stability through efforts aimed at reducing or preventing financial sector stress. Indeed, monitoring and promoting financial stability have become important parts of the IMF's mandate. The IMF is currently the one international organization capable of carrying out financial sector surveillance universally—that is, for all countries—and comprehensively. This chapter will examine the work of the IMF as it relates to financial stability, as well as touch on some of the reasons for IMF involvement in ensuring financial stability. The discussion will also identify the tools used by the IMF in its surveillance of financial sectors, examining the key procedures and operations applied in monitoring financial sectors. Finally, the discussion will conclude by identifying issues that should be considered in the context of the future work of the IMF in this field.

## Why Is the IMF Concerned About Financial Stability?

The core mandate of the IMF focuses on maintaining open economies, avoiding exchange restrictions, promoting balanced growth, and supporting monetary cooperation. These core objectives have not only remained unchanged over the years, but have acquired added significance given the challenges brought about by increasing globalization. Throughout the 1990s, and partly in response to the financial crises of that decade, the IMF strengthened its surveillance activities that related to assessing financial sector health and financial sector vulnerabilities.<sup>1</sup>

Financial instability has a number of negative consequences. For example, economies experiencing instability in their financial sectors are likely to suffer from an increase in volatility in financial markets. Through risk premiums, volatility will increase prices and wages, affecting the labor market as well as overall consumption patterns. In addition, depending on the nature and severity of the instability, economies that are interconnected with those experiencing instability are at risk of experiencing contagion effects. Finally, if the instability persists there will be negative effects on economic growth. Financial crises can be extremely costly in terms of lost growth; Table 1 provides some indication of the costs associated with financial crises in various countries throughout the past 25 years. Not even the United States has been immune to such costs.

The IMF's Executive Board has noted the key elements of effective surveillance to include timely, comprehensive, and accurate information; focused, high-quality analysis; openness to different perspectives to minimize the risk of "tunnel vision";<sup>2</sup> effective communication of assessments to the authorities and the public; and engendering the desired impact on members' policy decisions.<sup>3</sup> The Board has agreed that, building on the lessons learned from the Mexican and Asian crises of the 1990s, steps would be taken to shape IMF surveillance to better meet these criteria.<sup>4</sup> Consequently, IMF efforts to strengthen surveillance and crisis prevention have covered a wide range of areas, although, as indicated by the IMF Executive Board, there remains scope for further progress in many of them. The focus of these efforts has been on developing more systematic financial sector surveillance—in particular, through the Financial Sector Assessment Program (FSAP), but also through Article IV consultations,

the *Global Financial Stability Report*, and the *World Economic Outlook*. In addition, other important areas include improved data provision to the IMF and data dissemination to the public, as well as strengthened assessments of policy frameworks and institutions against internationally recognized standards and codes.

**Table 1. The Cost of Crises**

Country	Duration of Crisis	Cost (% of GDP)
Argentina	2001–2003	22
Chile	1981–1983	33
Ecuador	1998–2001	22
Finland	1991–1993	11
Indonesia	1997–2002	52
Korea	1997–2000	23
Mexico	1994–1995	19
Thailand	1997–2000	35
Turkey	2000–2003	31
United States	1984–1991	2

Source: IMF staff estimates.

## Tools of IMF Financial Sector Surveillance

### The FSAP

The FSAP is a joint initiative of the IMF and World Bank undertaken to provide member countries with a comprehensive evaluation of their financial systems and aims to reduce the likelihood and severity of financial crises. The program began in 1999, partly in response to the Asian financial crisis and to calls by the international community for intensified cooperative efforts to strengthen the monitoring of financial systems. Work under the program, which is supported by experts from a range of national agencies and standard-setting bodies, seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritize policy responses. The initial pilot program involved assessments of some 12 countries.<sup>5</sup> In 2000,

Executive Directors in both the IMF and World Bank acknowledged the quality of the work thus far and agreed that the program should be continued, with coverage being expanded to around 24 countries. By the end of 2004, roughly two-thirds of the membership, amounting to about 120 countries, participated in the program or agreed to participate in it in the near future.

In implementing the FSAP, IMF and World Bank staff are guided by the observations of the Executive Boards of both institutions. During the 2003 review of the FSAP, the IMF's Executive Board agreed that the FSAP had proven successful in providing a comprehensive and strategic framework to identify financial sector vulnerabilities; strengthening the analysis of domestic macroeconomic and financial stability issues; identifying development needs and priorities; and providing the authorities with appropriate policy recommendations.<sup>6</sup> However, the review noted that the cost of the FSAP had increased due in part to the bunching of assessments of a number of systemically important countries and to the increase in the average number of international standards and codes that are assessed in detail. Consequently, the Board noted that while the FSAP remained the key tool for strengthening the monitoring of financial systems, resource constraints demanded that additional tools be employed to maintain the depth and quality of financial sector surveillance in between comprehensive assessments.<sup>7</sup>

The 2003 review also discussed additional modifications to certain features of the FSAP. It was understood that the number of comprehensive assessments undertaken in each year would be reduced to between 17 and 19, permitting more of a qualitative focus on the effectiveness of the assessments, as opposed to a quantitative focus on conducting a certain number of assessments.<sup>8</sup> The need for greater selectivity in the scope of assessments was also discussed—the depth and intensity of the assessment of individual financial sector standards should be tailored to country circumstances and take into account the priorities of country authorities. In particular, in industrial countries, where the potential scope of the program is large, a two-stage approach might be appropriate in which a prioritized set of standards could be covered in the first stage, while the remaining standards could be assessed in the context of subsequent FSAP reassessments and updates. While there have been periodic modifications

to certain features of the FSAP, the importance of the program and its corresponding benefits have been affirmed by participating countries.

As one of the IMF's key surveillance instruments, the FSAP is designed to alert national authorities to likely vulnerabilities in their financial sectors—whether originating from inside the country or from outside sources—and to assist them in the design of measures that would address these vulnerabilities. The emphasis of this exercise is on prevention and mitigation rather than on crisis resolution. A key tool of the exercise involves stress tests. Stress tests aim to assess vulnerabilities arising from macro-financial linkages by assessing the impact of exceptional but plausible shocks to key macroeconomic variables on the soundness of the financial system. The findings supplement the FSAP analyses that use a number of other tools to analyze financial sector systemic risks and vulnerabilities. Stress tests also serve as a useful tool for the supervisory authorities and financial stability policymakers in the country, because they highlight risk measurement and management both at the individual financial institution level and at the systemic level.<sup>9</sup>

The FSAP exercise also ascertains the overall robustness of the financial sector's infrastructure. Sectoral developments, risks, and vulnerabilities are analyzed using a range of financial soundness indicators (FSIs).<sup>10</sup> FSIs are a new branch of economic statistics crossing several measurement disciplines. FSI data have, first, a prudential aspect that draws on the supervisory and financial accounting concepts developed to monitor the condition of individual financial institutions and, second, a macro aspect that looks at information on the sector as a whole drawing on economic statistical measures. Thus, they include both aggregated information on financial institutions and indicators that are representative of markets in which financial institutions operate. The FSIs typically encompass balance sheet and income information and indicators that are representative of markets in which financial institutions operate. Broadly, the FSIs would fall within the following categories: capital adequacy, asset quality (lending and borrowing institutions), profitability and competitiveness, liquidity indicators, and indicators of sensitivity to market risk.<sup>11</sup>



**Table 2. Core and Encouraged FSIs**

<b>CORE FSIs</b>	
<b>Deposit-takers</b>	
<i>Capital Adequacy</i>	Regulatory capital to risk-weighted assets Regulatory Tier 1 capital to risk-weighted assets Nonperforming loans net of provisions to capital
<i>Asset Quality</i>	Nonperforming loans to total gross loans Sectoral distribution of loans to total loans
<i>Earnings &amp; Profitability</i>	Return on assets (equity) Interest margin to gross income Noninterest expenses to gross income
<i>Liquidity</i>	Liquid assets to total assets Liquid assets to short-term liabilities
<i>Sensitivity to Market Risk</i>	Net open position in foreign exchange to capital
<b>ENCOURAGED FSIs</b>	
<b>Deposit-takers</b>	Capital to assets Large exposures to capital Geographic distribution of loans to total loans Gross asset (liability) position in financial derivatives to capital Trading income to total income Personnel expenses to noninterest expenses Spread between reference lending and deposit rates Spread between highest and lowest interbank rate Customer deposits to total noninterbank loans Foreign-currency-denominated loans (liabilities) to total loans (liabilities) Net open position in equities to capital
<b>Other Financial Corporations</b>	Assets to total financial system assets Assets to GDP
<b>Nonfinancial Corporations Sector</b>	Total debt to equity Return on equity Earnings to interest and principal expenses Net foreign exchange exposure to equity Number of applications for protection from creditors
<b>Households</b>	Household debt to GDP Household debt-service and principal payments to income
<b>Market Liquidity</b>	Average bid-ask spread in the securities market Average daily turnover ratio in the securities market
<b>Real Estate Markets</b>	Real estate prices Residential (Commercial) real estate loans to total loans

Source: IMF, *Compilation Guide on Financial Soundness Indicators* (July 30, 2004), <http://www.imf.org/external/np/sta/fsi/eng/2004/guide/chap1.pdf>.

The IMF promotes two sets of FSIs—a core and an encouraged set—which are set out in Table 2. Indicators of the core set (banking sector indicators) are expected to be more easily available and relevant to most countries, even those with relatively less developed financial systems. Based on data availability and financial structure they can be combined with selected additional indicators of the encouraged set (indicators relating to nonbank financial institutions and markets, the corporate sector, real estate markets, and households) that might be of particular relevance in the country concerned, depending on its level of financial development, institutional structure, and regional circumstances. The IMF's Statistics Department is involved in a compilation exercise attempting to collect core FSIs on a consistent basis for about 70 countries, as well as at least some of the encouraged set, as appropriate. It is expected that following the conclusion of the pilot phase, collection of FSIs will become a part of regular statistical reporting to the IMF.

Prior to the availability of fully consistent FSIs, countries and FSAP missions, as well as other IMF missions, are monitoring FSIs based on country-specific definitions. While this can limit intercountry comparability of some of the data, it does provide a set of indicators to be continuously monitored, and adverse changes indicate the need to take action.<sup>12</sup> Monitoring FSIs therefore helps to strengthen surveillance and monitoring of financial sectors, in particular once FSAP assessments have established a base line. They are intended to complement macroeconomic indicators, which also help to identify risks to financial stability, and may also be used to monitor the impact of policy action. Other structural underpinnings of financial stability—systemic liquidity arrangements; the institutional and legal framework for crisis management and loan recovery; and transparency, accountability, and governance structures—may also be examined to ensure a comprehensive assessment of both stability and developmental needs. In the FSAP context, the analysis of FSIs is becoming increasingly integrated with the stress-testing exercise. For example, previous work done on FSAPs has shown how FSIs can help the interpretation of stress tests by providing an indication of deterioration in financial conditions associated with a change in FSIs of a given size. At the same time, stress tests can provide a basis for interpreting, or benchmarking, future movements in FSIs.

As part of the process, the FSAP provides assessments of observance of various internationally accepted financial sector standards, set within the broader institutional and macroprudential context. The standards that have been assessed in the context of the FSAP—with country-specific prioritization of which standards were most relevant for assessment in each case—have been the Code of Good Practices on Transparency in Monetary and Financial Policies, the Basel Core Principles for Effective Banking Supervision, the Core Principles for Systemically Important Payment Systems, the International Organization of Securities Commissions Objectives and Principles of Securities Regulation, and the International Association of Insurance Supervisors Insurance Core Principles. Table 3 provides a comparison of the various standards used in assessments of some of the initial FSAP participants.

After a request has been initiated by a member country, the FSAP process begins with the selection of the FSAP team. Along with IMF and World Bank staff and contractual experts, the team may comprise experts from a range of cooperating central banks, supervisory agencies, standard-setting bodies, and other international institutions. Before the mission takes place, the team prepares and forwards a set of questionnaires to the country authorities; the topics covered form the basis for many of the discussions between the team members and country authorities. While on mission in the country, the team members meet with the staff of the central bank, the finance ministry, regulatory agencies, and financial institutions. Preliminary results are synthesized into the *aide-mémoire*, which is then provided to the country authorities prior to the team's departure.

The *aide-mémoire* is reviewed by other selected IMF and World Bank staff back in headquarters, and comments resulting from this review, as well as that of the county authorities, are incorporated into a final version. The *aide-mémoire* is a confidential working document and should not be authorized for publication.<sup>13</sup> However, the findings contained therein form the basis for separate summary reports prepared by IMF and World Bank staff for their respective institutions' Boards of Directors. The Financial System Stability Assessment (FSSA) is presented to the IMF's Board, while the Financial Sector Assessment (FSA) is reviewed by the World Bank's Board. The FSSA focuses on the linkages between the macroeconomy and the

**Table 3. Standards and Codes Assessed in the FSAP**

	Transparency in Monetary and Financial Policies (MFP)	Banking Super- vision (BCP)	Securities	Insurance (ICP)	Payment System (SIPS)
<b>FSAP Pilot</b>					
Cameroon	x	x		x	x
Canada	x	x	x	x	x
Colombia	x	x			
El Salvador	x	x			
Estonia	x	x	x	x	x
Hungary	x	x	x	x	x
India	x	x	x		x
Iran	x	x			
Ireland	x	x	x	x	x
Kazakhstan	x	x	x	x	x
Lebanon	x	x			
South Africa	x	x	x	x	x
<b>Post-Pilot</b>					
Armenia	x	x	x	x	x
Ghana	x	x		x	x
Guatemala	x	x			x
Iceland	x	x	x	x	x
Israel	x	x	x	x	x
Peru	x	x			x
Poland	x	x	x	x	x
Senegal	x	x	x	x	
Slovenia	x	x	x	x	x
Yemen	x	x			

Source: IMF, *Financial Sector Assessment Program—A Review: Lessons from the Pilot and Issues Going Forward*, November 27, 2001, [http://www.imf.org/external/np/fsap/2001/review.htm#tab\\_1](http://www.imf.org/external/np/fsap/2001/review.htm#tab_1).

soundness and operations of the financial sector, including regulatory and governance frameworks, and other stability and market integrity issues of relevance to IMF surveillance. In addition to presenting an overall stability assessment, the FSSA also contains summary assessments of relevant financial sector standards—these summaries are also issued as Reports on Observance of Standards and Codes (ROSCs) for the financial sector.<sup>14</sup> Furthermore, the team provides the country authorities with two additional reports—a Detailed Assessment of the Observance of Standards and Codes, which contains assessments of the observance of selected financial sector standards, codes, and good practices; and *Selected Financial Issues*, which is a detailed and technical analysis that is the basis of the aide-mémoire and the FSSA. These reports are exclusively for the authorities of the countries and not communicated to the Executive Boards of the IMF and the World Bank.<sup>15</sup>

### ***Lessons from the FSAP***

The FSAP has been a successful program, with more than half of the membership having been assessed. In addition, the assessments have cut across the wide range of the membership, including most of the Group of Seven (G-7) countries as well as many developing and emerging market countries.<sup>16</sup> The FSAP reports have provided some general indications of the issues facing the financial sectors in similarly positioned countries. For example, in many of the developing countries the systems are dominated by banks, and the recommendations have often placed an emphasis on developing nonbank financial institutions in these countries. In addition, the evidence often reveals significant balance sheet vulnerabilities to macroeconomic shocks in these countries along with significant shortcomings in legal and regulatory frameworks. In emerging market economies there are generally fewer instances in which significant balance sheet vulnerabilities present themselves; however, there are sometimes concerns regarding the enforcement of the regulatory framework as well as deficiencies in nonbank supervision and regulation. This contrasts to the situation revealed in developed countries where, generally, the financial systems are sound and well-supervised, and where more concern would be focused on challenges arising from consolidation, globalization, and financial innovation.

Countries are increasingly undertaking their own efforts to strengthen financial sector surveillance. In a growing number of countries—often spurred by an FSAP report—central banks conduct their own financial stability analyses and publish financial stability reports.<sup>17</sup> Notwithstanding such reports, FSAP reports often afford important complementary elements. Stability reports typically rely on indicators that are equivalent to FSIs; however, many do not assess compliance with international standards and codes. The ability of the IMF and World Bank to provide independent assessments is an important advantage to the FSAP. This advantage extends to other aspects of the FSAP as well. For instance, system-focused stress tests are a standard component of the FSAP, while financial stability reports carried out by central banks make limited use of this tool. The FSAP assessments also could be seen as having an advantage in covering issues that involve several institutions and agencies, such as systemic liquidity or a framework for crisis management.

As time goes on, the FSAP will continue to provide key lessons on the nature of financial sector issues, while playing an important role in informing country authorities of developments in their financial sectors and encouraging other countries to undertake their own financial stability reporting efforts.

#### **Article IV Consultations**

Periodic, mostly annual, Article IV country consultations have traditionally been the cornerstone of IMF surveillance, and, while new tools such as the FSAP have been introduced to allow for a comprehensive assessment of a member's financial sector, the Article IV consultations remain a key aspect of the IMF's overall surveillance efforts, providing systematic and ongoing financial sector surveillance covering the whole membership. Generally, IMF surveillance reflects a number of distinct purposes—including, briefly, provision of policy advice; assessment of coordination among key macroeconomic policies; information gathering and dissemination; review of technical assistance needs; and identification of vulnerabilities. The Article IV consultations address many aspects of these purposes, but to better grasp the specific, and evolving, nature of the Article IV consultation, an initial review of the IMF Articles of Agreement is instructive.

Article IV of the IMF's Articles of Agreement addresses obligations regarding exchange arrangements. In outlining the general obligations of the members, Section 1 states, "Recognizing that ... a principal objective [of the international monetary system] is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." Section 3(a) provides that the IMF "shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." In order to fulfill this function, Section 3(b) provides that the IMF "shall exercise firm surveillance over the exchange rate policies of members with respect to those policies."

In a decision of the IMF Executive Board in 1977, the IMF set out the general principles for the conduct of surveillance.<sup>18</sup> This decision establishes that surveillance over members' exchange rate policies requires a comprehensive assessment of the members' general economic situation and economic policy strategy. The surveillance procedures provide that these assessments shall be conducted against the ultimate objectives of financial stability, sustained sound economic growth, and reasonable levels of employment. The procedures also recognize the importance of adapting surveillance to "the needs of international adjustment as they develop."

In the context of financial system stability, the surveillance efforts under Article IV were in the past focused chiefly on members' exchange rate policies; however, the IMF has recognized that surveillance should no longer be limited to fiscal, monetary, and exchange rate policies, but, drawing on the general oversight responsibilities outlined in Section 3(a), should include other critical economic issues. In monitoring financial systems, Article IV consultation missions now focus on (1) conditions and developments in the banking and financial system and markets that may disrupt macroeconomic conditions and policies; (2) macroeconomic conditions and developments that may impinge upon the financial system; and (3) aspects of the institutional, legislative, supervisory, and prudential regulation frameworks that could entail risks for the soundness of the financial system. Other aspects often covered during the missions in-

clude the activities of the offshore financial centers (OFCs) and anti-money laundering and combating the financing of terrorism efforts. It should be noted that the primary responsibility for financial sector surveillance in the context of Article IV consultations lies with the IMF area departments. However, area department staff will often require special support from financial sector experts in other IMF departments to ensure adequate coverage of financial sector issues in Article IV consultations.

For surveillance efforts to be effective, individual Article IV consultations need to retain a clear focus on the key issues in each country. This requires *selectivity* according to country-specific circumstances.<sup>19</sup> Article IV reports should clearly indicate the focus of the discussions. Selectivity should be guided by the following principles: (1) within the expanded scope of surveillance, the selection of topics to be covered in surveillance discussions with a member should be based on macroeconomic relevance; and (2) within these selected topics, the issues at the apex of the Fund's hierarchy of concerns should be those related to external sustainability, vulnerability to balance of payments or currency crises, sustainable growth with price stability, and, for systemically important countries, conditions and policies affecting the global or regional economic outlook.

In principle Article IV consultations take place on an annual basis. Article IV consultations involve multiple steps and outputs including compilation of economic and financial data, production of analytical studies, dialogue with country authorities, communications with nonofficials, and written reports. As with the FSAP, IMF staff visit the member country to gather information and hold discussions with government and central bank officials and, often, private investors, labor representatives, members of parliament, and civil society organizations. Upon return, the mission submits a report to the IMF's Executive Board for discussion. The Board's views are subsequently summarized and transmitted to the country's authorities.

An Article IV staff report would typically include a special section discussing financial sector issues, covering key vulnerabilities and structural weaknesses as well as the policies required to address them. The section would include a table on selected FSIs and other relevant indicators, as available, and a description of the key institutional features of the financial system, as relevant. Further, the section



would include a discussion of (1) the relative importance of the main segments of the financial sector and domestic and international linkages among sectors; (2) the financial condition of the most important segments of the financial sector; (3) the key risks and structural concerns as a result of meetings with the supervisory authorities; and (4) key developmental issues relating to the strengthening of institutions, governance, and legal frameworks. Finally, the discussion would highlight areas that, because of lack of information or resource constraints, have not yet been adequately covered, and require further examination.

In countries for which a recent FSAP assessment, an FSAP reassessment, or FSAP update is available, a sufficient coverage of the financial sector will have been provided as a result of the FSAP. In such cases, financial sector surveillance in the Article IV consultation focuses on the FSSA report. In particular, FSAP findings are discussed with the authorities during the Article IV mission, the FSSA—a report summarizing the assessment—accompanies the Article IV staff report, and the main findings and policy recommendations contained in the FSSA are presented in the Article IV staff report. The FSSA also contains the summary ROSCs assessed in the FSAP. In cases where a previous FSAP assessment or update identified significant vulnerabilities or important structural weaknesses, the coverage of financial sector surveillance in the Article IV consultation should include an update of progress in implementing the recommendations of the FSSA. This update should focus on those recommendations that were assigned the highest priority in the FSSA, including those followed up with technical assistance.

The 2004 review of surveillance noted an improvement in the coverage of financial sector issues in recent years, but it also acknowledged that a further strengthening is required to elevate this coverage to the level established for other main areas.<sup>20</sup> Coverage also varies substantially across countries, being generally quite broad for emerging market countries and providing substantial insights into macro-financial linkages, whereas it is more selective for industrial countries and rather uneven for developing countries.<sup>21</sup> Such variance is partially due to the intensity of concerns about financial sector weaknesses. It also reflects the allocation of financial sector expertise—that is, the quality of coverage tends to be more robust in consultations with substantial participation from the staff of the Monetary

and Financial Systems Department and the International Capital Markets Department. In the future, efforts will be made to continue improving the treatment of financial sector issues in surveillance. As indicated by the IMF Executive Board at the conclusion of the last FSAP review, these efforts cannot be expected to rely solely on full FSAP assessments, given resource constraints and the voluntary nature of this program, and other options will need to be considered.<sup>22</sup>

### **Multilateral Surveillance in the Context of the *Global Financial Stability Report* and the *World Economic Outlook***

In practice, surveillance is conducted through various vehicles within the IMF. In IMF terminology, it is customary to use the expressions *bilateral* and *multilateral* to characterize the two broad categories of surveillance activities. Bilateral surveillance, as discussed earlier, is typically conducted through the Article IV consultation process undertaken by all member countries, but it may also take place through program reviews associated with the IMF's financial assistance, the FSAP, technical assistance, or other formal and informal processes directed at individual countries. Multilateral surveillance, perhaps more difficult to define, may be thought of as "global surveillance" or surveillance of global linkages.<sup>23</sup> In practice, however, not all countries are equally relevant for this purpose. In the past, multilateral surveillance effectively meant surveillance of large industrial countries because, given their weight in the world economy, most of the global economic developments were driven by their policies. As other countries begin to influence the global economy, and with systemic financial vulnerability issues having assumed greater importance, the scope of multilateral surveillance has widened.<sup>24</sup> As part of the institution's multilateral surveillance, IMF missions visit member countries' main financial centers, both in industrialized and emerging economies, to discuss developments in national and international financial markets with commercial and investment banks, securities firms, stock and futures exchanges, regulatory and monetary authorities, and credit rating agencies.

The main products of the IMF's multilateral surveillance efforts, the *Global Financial Stability Report* and the *World Economic Outlook*, focus the international community's attention on key issues in

financial sectors.<sup>25</sup> The *Global Financial Stability Report* replaced two earlier IMF publications: the annual *International Capital Markets Report* (published since 1980) and the quarterly *Emerging Market Financing* (published since 2000). It was created to provide a more frequent assessment of global financial markets and to assess global financial market developments with the view to identifying potential weaknesses. The report focuses on current conditions in global financial markets, highlighting issues of financial imbalances, and of a structural nature, that could pose a risk to financial market stability and sustained market access by emerging market borrowers. By drawing attention to these imbalances, the report seeks to play a role in preventing crises, and thereby contribute to global financial stability. As a biannual report, its focus is on relevant contemporary issues, rather than a comprehensive survey of all potential risks, and on elaborating the financial ramifications of economic imbalances highlighted by the *World Economic Outlook*.

The *World Economic Outlook* presents the IMF staff's analysis and projections of economic developments at the global level. Throughout the 1970s, preparation and discussion of the *World Economic Outlook* was primarily an internal exercise at the IMF, remaining so until 1980, when the decision was made to publish the report.<sup>26</sup> Throughout the 1980s the *World Economic Outlook* grew to become more than a forecasting exercise, focusing increasingly on elaborating policy options available to member governments. The analysis and projections contained in the publication have now become integral elements of the IMF's surveillance of economic developments and policies in its member countries, as well as of developments in international financial markets. The analysis of countries, often broken into major country groups classified by region or stage of development, focuses on major economic policy issues as well as on the analysis of economic developments and prospects. It is usually prepared twice a year, with its release coinciding with the meetings of the International Monetary and Financial Committee, and is the IMF's principal vehicle for multilateral surveillance. It is the foundation for integrating the analysis of developments in individual countries into a larger multilateral context.

There are a number of challenges currently facing the IMF's multilateral surveillance initiatives. A number of reviews have suggested that the linkages between bilateral and multilateral surveillance efforts

could be further integrated and thereby strengthened.<sup>27</sup> A recent report noted that progress has been made in integrating the quantitative aspects of bilateral and multilateral analysis; more specifically, country databases feed into *World Economic Outlook* projections while country desks make use of *World Economic Outlook* forecasts.<sup>28</sup> Nevertheless, the latest biennial review noted that there was still “substantial room to strengthen the analysis of regional and global spillovers” and staff reports for Article IV consultations contained very little discussion of the impact of global economic conditions and risks. In addition, there are times when IMF advice appears to have little influence on the policy decisions of major countries. Consequently, efforts may need to be increased to improve the level of influence of the policy discussion contained in the multilateral surveillance products, or these products may come to be viewed as better suited to providing exclusively objective policy analysis. Another challenge concerns the scope of multilateral surveillance, and whether the IMF should continue to focus its efforts on its traditional areas of expertise, or expand the scope to include other issues facing the world economy. This issue is in general repeatedly addressed in the periodic surveillance reviews, and at present, the IMF’s Executive Board has endorsed a measured approach in this area, recognizing the value of addressing issues related to the investment climate and institutional reforms in a country, while at the same time calling for greater selectivity in coverage of the nontraditional areas.<sup>29</sup>

## Conclusion

Many forces are constantly at work in the international financial system causing uncertainties and instability. The IMF is among the key international organizations striving to lessen the uncertainties and smooth the instability. Among the most important contributions to these efforts are the various bilateral and multilateral surveillance initiatives that the IMF staff execute on a regular basis.

The nature of global financial relations and the attendant risks continue evolving. Greater international financial integration and, in particular, the rapid increases in global capital flows over the 1990s have created new risks for countries, in particular those with vulnerable financial sectors. The IMF undertakes periodic reviews of the effectiveness of its surveillance activities, and—recognizing the newly emerging financial sector risks—has responded by augmenting

the Article IV consultation—the more traditional form of surveillance—with the FSAP and other efforts more specifically focused on uncovering financial sector risks. The creation of these new tools is a good indication that the IMF will—through its continuous efforts to detect imbalances and formulate recommendations to correct the imbalances—continue its efforts to reduce the likelihood of future financial crises, lessening the hardships faced by all those who rely on smoothly functioning financial systems.

## Notes

<sup>1</sup> Surveillance is the process of regular dialogue and policy advice that the IMF is mandated to provide to its members, covering macroeconomic and financial developments and policies in their countries. The IMF has been working to improve the surveillance process by deepening its coverage of financial system issues and, in particular, by promoting the Financial Sector Assessment Program (FSAP). These efforts are intended to better identify financial system strengths and weaknesses, and thereby lessen the frequency and diminish the intensity of potential financial system problems.

<sup>2</sup> “Tunnel vision” refers to the danger that the analysis underlying the surveillance exercise may miss key vulnerabilities, be unduly influenced by a country’s good past performance, or, in countries with IMF arrangements, by the agreed program framework. *See, e.g.*, IMF, “Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision: Surveillance in a Program Environment,” March 15, 2002, at 17, <http://www.imf.org/external/np/pdr/surv/2002/031502.pdf>, discussing opportunities for the Executive Board to provide guidance regarding surveillance in program countries that would highlight the need for a “fresh and independent look.”

<sup>3</sup> IMF, “Enhancing the Effectiveness of Surveillance: Operational Responses, the Agenda Ahead, and Next Steps,” March 14, 2003, <http://www.imf.org/external/np/pdr/surv/2003/031403.htm>.

<sup>4</sup> IMF, “Enhancing the Effectiveness of Surveillance: Operational Responses, the Agenda Ahead, and Next Steps,” Public Information Notice No. 03/50, April 10, 2003, <http://www.imf.org/external/np/sec/pn/2003/pn0350.htm>.

<sup>5</sup> In the context of the present discussion, the term “country” includes territorial entities for which statistical data are maintained on a separate and independent basis, even though they are not states as understood by international law and practice. For example, the Eastern Caribbean Currency Union or ECCU, which is a currency union of six member countries and two territories, is counted as one FSAP assessment.

<sup>6</sup> IMF, “The Acting Chair’s Summing Up—Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward,” March 18, 2003, *Selected Decisions and Selected Documents of the IMF, Twenty-Eighth Issue* (Washington: IMF, 2003) [hereinafter *Selected Decisions*], at 179.

<sup>7</sup> The Board agreed that the additional instruments would include reassessments, focused updates, work undertaken during Article IV consultation missions, and ongoing monitoring of financial sector developments and policy issues from headquarters. *Id.* at 181.

<sup>8</sup> In the Executive Board's 2005 review of the FSAP, it was agreed that the average frequency of FSAP updates would be roughly five years. The update would comprise, at minimum, an assessment of financial sector developments and progress in implementing earlier FSAP recommendations. IMF, "IMF Executive Board Reviews Experience with the Financial Sector Assessment Program," Public Information Notice 05/47, April 6, 2005, at 3.

<sup>9</sup> IMF and World Bank, *Analytical Tools of the FSAP* (Washington: IMF, 2003), <http://www.imf.org/external/np/fsap/2003/022403a.pdf>.

<sup>10</sup> The IMF's Executive Board originally endorsed a list of both core and encouraged macroprudential indicators (later renamed FSIs) in June 2001. See IMF, "Concluding Remarks by the Acting Chairman of the IMF Executive Board—Macroprudential Indicators," June 25, 2001, <http://www.imf.org/external/np/mae/fsi/2001/eng/062501.htm>. In 2003, the IMF's Executive Board reviewed progress on the FSIs and welcomed the work by country and international agency experts on the FSIs. IMF, "IMF Executive Board Discusses Financial Soundness Indicators," Public Information Notice 03/71, June 13, 2003, <http://www.imf.org/external/np/sec/pn/2003/pn0371.htm>. See IMF, "Compilation Guide on Financial Soundness Indicators," July 30, 2004, <http://www.imf.org/external/np/sta/fsi/eng/2004/guide/index.htm>.

<sup>11</sup> See V. Sundararajan et al., *Financial Soundness Indicators: Analytical Aspects and Country Practices*, IMF Occasional Paper No. 212 (Washington: IMF, 2002), explaining these FSI categories in the context of their use in macroprudential analysis. See generally, G. Slack, *Availability of Financial Soundness Indicators*, IMF Working Paper 03/58 (Washington: IMF, 2003).

<sup>12</sup> Intercountry comparability of FSIs is sometimes limited by country-specific definitions. An example is the definition of nonperforming loans where some countries count a credit as nonperforming after three months of nonpayment of principal and interest, whereas others would use a six-month threshold. Such differences do not matter when examining changes for one country over time.

<sup>13</sup> IMF, "Summing Up by the Acting Chairman—Financial Sector Assessment Program—A Review—Lessons from the Pilot and Issues Going Forward," *Selected Decisions*, at 184. The procedures designed to ensure the confidentiality of sensitive information obtained through the FSAP are set out in the Confidentiality Protocol, a document that was jointly agreed to by the IMF and World Bank in 2000. See IMF, *Selected Decisions*, at 185–92.

<sup>14</sup> Like the FSAP report, the ROSC is prepared in response to a request from a member country; however, unlike the FSAP report, the ROSC can be prepared separately by either IMF or World Bank staff and need not be con-

fined to financial sector issues. For an informative discussion of the relationship between FSAP reports and ROSCs, see F. Gianviti, “Legal Aspects of the Financial Sector Assessment Program,” in *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington: IMF, 2005), at 222–25.

<sup>15</sup> These reports can, however, be published if the country seeks the IMF Managing Director’s consent to do so. In practice, most countries choose to use these documents for internal purposes only and not to publish them.

<sup>16</sup> Given the voluntary nature of the FSAP, some systemically important member countries have, however, not yet volunteered.

<sup>17</sup> The first financial stability reports were published in the mid-1990s in the United Kingdom and several Nordic countries, but by 2004 the number of countries publishing such reports grew to 25. See IMF, “Financial Sector Assessment Program—Background Paper,” February 22, 2005, at 7, <http://www.imf.org/external/np/fsap/2005/022205a.pdf>.

<sup>18</sup> IMF, “Surveillance over Exchange Rate Policies,” Decision No. 5392-(77/63), as amended, *Selected Decisions*, at 10.

<sup>19</sup> See IMF, “Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Overview” (July 2004), at 5, <http://www.imf.org/external/np/pdr/surv/2004/082404.pdf#modalities>.

<sup>20</sup> IMF, “Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Overview” (July 2004), <http://www.imf.org/external/np/pdr/surv/2004/082404.pdf#modalities> (IMF staff review of surveillance), and IMF, “The Chairman’s Summing Up—Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision,” July 23, 2004, *Selected Decisions and Selected Documents of the IMF, Twenty-Ninth Issue* (Washington: IMF, 2005) [hereinafter *Selected Decisions, 29th Issue*], at 52.

<sup>21</sup> IMF, “Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Overview” (July 2004), <http://www.imf.org/external/np/pdr/surv/2004/082404.pdf#modalities>.

<sup>22</sup> IMF, “*IMF Reviews Experience with the Financial Sector Assessment Program and Reaches Conclusions on Issues Going Forward*,” Public Information Notice No. 03/46, April 4, 2003, <http://www.imf.org/external/np/sec/pn/2003/pn0346.htm>. Other options include, for example, focused FSAP updates, participation by staff from the Monetary and Financial Systems and International Capital Markets Departments in Article IV missions (or separate missions by these staff), monitoring of financial sector developments from IMF headquarters, and training of area department staff by staff in the Monetary and Financial Systems Department.



<sup>23</sup> Independent Evaluation Office, "The IMF's Multilateral Surveillance: Draft Issues Paper for an Evaluation by the Independent Evaluation Office" (June 2005), <http://www.imf.org/external/np/ieo/2005/ms/eng/061405.pdf>.

<sup>24</sup> In some cases, the term "multilateral surveillance" is used to emphasize the peer review aspect of surveillance designed to facilitate policy coordination. This was the sense in which the term was used, for example, in the context of the G-7 framework in the 1980s. *Id.* at 5. Regional surveillance is also an area in which the IMF has become much more effective in recent years, evidenced by surveillance activities relating to monetary unions and the production of various regional economic outlooks.

<sup>25</sup> Other products of multilateral surveillance include internal World Economic and Monetary Developments exercises, confidential staff vulnerability exercises, and the IMF's inputs into G-7 and G-20, Working Party 3 of the Organization For Economic Cooperation and Development, and the Financial Stability Forum.

<sup>26</sup> The first published *World Economic Outlook* appeared in May 1980, and, by 1984, it was expanded to a semiannual publication schedule. James M. Boughton, *Silent Revolution: The IMF 1979–1989* (Washington: IMF, 2001), at 227–30.

<sup>27</sup> In the 2002 biennial review of surveillance, the Executive Board stated that "... there remains scope for better integration of multilateral surveillance with bilateral surveillance." *Selected Decisions*, at 30. Similarly, in the 2004 review, the Board took the position that "... Fund surveillance is an ideal vehicle to analyze global and regional spillovers" and that there was "... substantial room to improve treatment of these issues through greater integration of bilateral, regional, and multilateral surveillance." IMF, "The Chairman's Summing Up—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision," July 23, 2004, *Selected Decisions*, 29th Issue, at 51. An independent report in 1999 described the transfer of knowledge across departments within the IMF, as viewed by internal observers, as insufficient. The report found that "in the surveillance context, this manifests itself in an inadequate cross-fertilization between multilateral and bilateral surveillance, and in insufficient use of what is learned in different countries." *External Evaluation of IMF Surveillance*, Report by a Group of Experts (Washington: IMF, 1999), at 13.

<sup>28</sup> Independent Evaluation Office, *supra* note 23, at 8.

<sup>29</sup> IMF, "The Chairman's Summing Up—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision," July 23, 2004, *Selected Decisions*, 29th Issue, at 50 and 53.

**Recognition of Governments in International Organizations, Including at the International Monetary Fund**

RAMANAND MUNDKUR

A country's relations with other subjects of international law are generally conducted through its government. If a government changes in a constitutionally accepted way the change does not alter international legal relations. However, when a country's government is changed in extra-constitutional ways (e.g., by coups d'état or foreign occupation), such changes do affect the country's international legal relations. A key issue to be addressed in these cases is whether the new entity can be regarded as the country's government in its relations with other subjects of international law.

This chapter reviews how international organizations, including the International Monetary Fund (IMF), reach decisions to recognize or deal with an entity as a member country's governments when that member country experiences such extra-constitutional changes in its government. The first section of this chapter provides a context to the review. It initially clarifies the scope of the review, with particular reference to the object being recognized. It then turns to examine the criteria, if any, that countries apply when recognizing foreign governments that come to power by extra-constitutional means. It also examines the legal implications of such recognition. The second section contains a similar assessment, but of the criteria used in international organizations. It also examines the implications of such decisions for those other organizations. Finally, the discussion turns to the criteria applied in the IMF and the implications of such decisions to deal with an entity as a member's government on relations between the member and the IMF.

## Countries

### The Object Recognized

“The recognition of a new government is quite different from the recognition of a new state.”<sup>1</sup> Put another way, it is not possible to recognize an entity as a country’s government without recognizing the territory the entity governs as a country.<sup>2</sup> However, it is possible to recognize a country but not recognize any government for that country.<sup>3</sup>

Sometimes, this distinction is given insufficient attention because many scholars tend to deal with both subjects in the same discussion (i.e., on the broader concept of “recognition” in international law).<sup>4</sup> Such a conflated treatment of the two subjects is largely driven by convenience: some considerations that apply to discussions on the recognition of countries also apply to discussions on the recognition of governments.<sup>5</sup> Still, these same scholars do highlight the distinction between the recognition of countries and the recognition of governments<sup>6</sup> and it is important for present purposes to emphasize that distinction.<sup>7</sup> This discussion deals exclusively with questions related to the recognition of governments; it does not deal with questions related to recognition of countries.

### Criteria Influencing the Recognition of Governments by Countries

Certain concepts, such as effective control of a territory,<sup>8</sup> or legitimacy,<sup>9</sup> have frequently been identified as criteria that may influence decisions concerning the recognition of foreign governments by countries. However, these criteria have been applied inconsistently and there is no well-settled legal criterion applied by any country when determining its recognition of a foreign government that has come to power in an extra-constitutional manner.<sup>10</sup>

The absence of any clear criterion probably arises from three related sources. First, recognition is “founded” on the intent of the country extending recognition.<sup>11</sup> Determining the existence and nature of any such subjective attribute is always a difficult and complex undertaking. Second, it is now widely accepted that when a country

recognizes an entity as the government of another, such acts involve an exercise by the recognizing country of its sovereign rights.<sup>12</sup> Each country is therefore free to recognize or to abstain from recognizing a government in another country,<sup>13</sup> and one country's recognition, non-recognition, or de-recognition of a foreign government cannot be challenged or disputed by another.<sup>14</sup> Third, questions of recognition of governments by countries are dealt with and resolved as political questions rather than as legal questions.<sup>15</sup>

It is therefore not surprising that different countries have applied different criteria when recognizing foreign governments established in extra-constitutional ways. For that matter, even different governments of the same country may have applied inconsistent criteria when recognizing foreign governments.<sup>16</sup>

The predominantly political nature of recognition has not merely resulted in the absence of legal criteria for recognition of governments by countries. It has materially diluted the legal significance of formal statements in which the word "recognition" (or a variant) is used with respect to an extra-constitutionally established entity administering another country. It has also complicated attempts to identify whether one country has or has not recognized an entity as the government of another.

For example, to avoid problems of imputing legitimacy to entities that come to power by extra-constitutional means,<sup>17</sup> many countries have sought since the 1970s to deemphasize the concept of "recognition of governments" in their public statements.<sup>18</sup> These countries focus, instead, on whether they would be willing to "deal with" an authority as a government. This distinction leads to more than just political nuance. It can be the source of much confusion because some countries take pains to emphasize that dealing with an entity as a government need not imply recognition.<sup>19</sup>

A similar and related source of confusion is the attempt at distinctions between *de jure* and *de facto* recognition of governments or (in a more semantically accurate variant) between the recognition of *de jure* and *de facto* governments. There have been instances when a country declares that it "recognizes" an entity as another country's *de facto* government.<sup>20</sup> However, as one scholar notes, such statements are based on either "a purely political judgment" or "a legal determi-

nation of the existence of an effective government, but with reservations as to its permanence and viability.”<sup>21</sup> Today, there is no material distinction in international law between *de jure* and *de facto* recognition (or between the recognition of *de jure* and *de facto* governments for that matter).<sup>22</sup> If anything, the possible co-existence of two different governments for one country (i.e., one *de facto* and the other *de jure*), can only serve to render extremely tenuous the status of any international legal relations sought to be created by either. For example, if one entity were to enter into commitments that sought to bind the country it purported to represent, the validity of such commitments might be challenged by the other entity.

A third source of confusion is that the recognition of governments is most readily manifest through the designation of formal diplomatic status to the entity recognized as the government.<sup>23</sup> Yet, recognition is distinct from maintaining diplomatic relations. Therefore, a country may recognize an entity as the government of another but refrain from maintaining any diplomatic relations with that other country.<sup>24</sup> Conversely, dealings between an unrecognized entity and a consular office need not imply recognition of that entity as a government.<sup>25</sup>

These complexities, often based on politically expedient actions or statements, create the potential for significant legal pitfalls, and various theories on recognition have “deflected lawyers from the application of ordinary methods of legal analysis.”<sup>26</sup> To avoid such pitfalls, and particularly since the issue is fundamentally a question of intention, the existence or absence of recognition by a country needs to be assessed by reference to “*all* ... legally significant conduct and declarations.”<sup>27</sup> Stated another way, a single act or declaration may be evidence (even strong evidence) of recognition, but the existence of such recognition can only be ascertained by regarding all legally relevant evidence. Further, such an assessment of recognition, that is, one based on a consideration of all legally relevant evidence, is consistent with ordinary methods of legal analysis used in situations where the existence or nonexistence of a legally critical fact has to be determined from conflicting statements, actions, or omissions.<sup>28</sup>

## **Implications Arising from the Recognition of Governments by Countries**

One cannot adequately stress the need to consider all legally relevant evidence when determining the existence or absence of recognition, because recognition has significant implications in international law. Perhaps the most significant implication in the international legal realm is that only an entity recognized as a country's government can represent the country in a way that creates international obligations that are binding on the country. In contrast, entities that are not recognized as governments have only been allowed to enter into agreements in their own name or on behalf of their movement, not on behalf of the country they purport to represent.<sup>29</sup>

There are other significant international law implications that arise when an entity is recognized as a country's government—for example, whether the entity can legally exercise the country's international rights, or whether the entity's wrongful conduct can legally be attributed to that country under international law.<sup>30</sup>

Recognition of an entity as a foreign country's government also has important practical consequences in the sphere of domestic law. Such recognition affects, among other things, the entity's ability to assert sovereign immunity,<sup>31</sup> access domestic courts,<sup>32</sup> or seek entitlement to the foreign country's property situated in the recognizing country.<sup>33</sup> However, in these cases local courts are often obliged as a matter of public law to follow the advice of their executive branch of government. The local courts' responses to questions of recognition therefore frequently reflect the (mainly political) policies of the country extending recognition. For this reason, one leading scholar urges "great caution ... in using municipal cases to establish propositions about recognition in general international law."<sup>34</sup>

## **International Organizations**

### **Criteria Influencing the Recognition of Governments in International Organizations**

The recognition of governments by countries may be resolved as a political matter. However, to the extent that international organiza-

tions are expected to be neutral, the resolution of this issue in international organizations should be founded on a firmer legal basis. Further, unlike international organizations, a country may “recognize” one entity as another country’s government but refrain from dealing with that entity.<sup>35</sup> If an international organization recognizes an entity as a member’s government, it must then deal with that entity as a government.<sup>36</sup>

Consequently, the recognition of a government in an international organization is distinct from and may not be based on the recognition of the government by every single country that is a member of the international organization.<sup>37</sup> Moreover, given the independence of international organizations from each other, the practices followed by different international organizations in recognizing or dealing with authorities as governments also differ. To demonstrate the nature of these differences, it is useful to compare the practice and policies of the United Nations (UN) with the practice and policies of the specialized agencies including the World Bank.

The United Nations relies on recognition established through a procedure involving its credentials committee. Under this system, when the credentials of a disputed government are filed with a UN organ, the question of recognition is discussed in the UN credentials committee. Based on the committee’s report, the credentials are then evaluated by the UN organ concerned. Pending this determination, and until the credentials are formally rejected, the delegation whose credentials are disputed can participate with full rights in that organ’s session.<sup>38</sup>

To avoid the possibility that different UN organs reach different determinations, the fifth session of the General Assembly recommended that when more than one authority claims to be the government entitled to represent a member at the United Nations, the matter should be considered by the General Assembly.<sup>39</sup> It further recommended that the attitude adopted by the General Assembly should be taken into account in other UN organs and in the specialized agencies.<sup>40</sup>

The General Assembly resolution has had little impact on recognition of governments in the specialized agencies for various reasons.

First, the specialized agencies are independent organizations with competence to take their own decisions.<sup>41</sup> Second, General Assembly resolutions are recommendations that are not intended to bind even UN members.<sup>42</sup> Third, the specialized agencies often have to make their determinations on recognition before the General Assembly makes its own determination, which typically only occurs at the end of the relevant General Assembly session.

As the 1993 case of Zaïre (now the Democratic Republic of the Congo) demonstrates, the specialized agencies' conclusions can widely differ from the General Assembly's conclusions. In 1993, questions arose as to whether Zaïre should be represented based on credentials issued by the Minister of Foreign Affairs in President Mobutu's government or those issued by Zaïre's Permanent Mission in Geneva on behalf of the transitional government of Prime Minister Tshisekedi. The World Health Organization's general congress, the World Health Assembly, decided to accept the credentials of both delegations.<sup>43</sup> The International Labor Organization decided that it had an insufficient basis to make a choice between the two sets of credentials, but that it would recognize the credentials issued by Zaïre's Permanent Mission in Geneva on the understanding that such recognition "did not imply a recognition of the government whose representatives were included on those credentials, such recognition being a question for the United Nations General Assembly."<sup>44</sup> Later that year, the General Assembly decided by consensus to accept the credentials of the Mobutu government.<sup>45</sup>

The relationship between the acceptance of credentials and the recognition of governments needs some clarification. An international organization may recognize a government but not accept the credentials of a delegation purporting to represent that government; for instance, because of a formal defect in the credentials.<sup>46</sup> On the other hand, it was generally assumed that, when an international organization accepted credentials, such acceptance signified the international organization's recognition of the government issuing the credentials.<sup>47</sup>

However, recent events concerning the Iraqi delegation to the 58th session of the UN General Assembly test the limits of even this assumption. The (sole) Iraqi delegation to the General Assembly session was accredited by a letter dated September 17, 2003, signed by



the Minister for Foreign Affairs designated by Iraq's Governing Council. The UN credentials committee accepted this letter as credentials submitted in due form.<sup>48</sup> On December 17, 2003, the General Assembly approved the UN credentials committee's report, without comment. However, during this time, the provisions of Security Council Resolution No. 1483 (2003) were also applicable.

In this resolution, the Security Council, acting under Chapter VII of the UN Charter, explicitly recognized the specific authorities, responsibilities, and obligations under applicable international law of the United States and the United Kingdom "as occupying powers under unified command" (i.e., the Coalition Provisional Authority). Furthermore, Regulation 6 issued by the Coalition Provisional Authority only recognized the Governing Council "as the principal body of the Iraqi interim administration, *pending the establishment of an internationally recognized, representative government* by the people of Iraq, consistent with Resolution 1483."<sup>49</sup> (Italics added.) Since there was no internationally recognized government in Iraq when the credentials of the Iraqi delegation were accepted without comment, a question arises as to the capacity in which this Iraqi delegation participated in the General Assembly session.

Some specialized agencies have adopted operational policies that guide their work to deal with such situations. For instance, the World Bank has a specific operational policy on "Dealings with De Facto Governments."<sup>50</sup> (A copy of this policy is provided as Appendix II to this volume.)

Given the issues raised in the preceding discussion on recognition of governments by countries, it is not surprising that the policy explicitly clarifies that the Bank's dealing with a de facto government pursuant to the policy "does not in any sense constitute Bank 'approval' of the government, nor does refusal indicate 'disapproval.'"<sup>51</sup> From the way the policy has been structured, it also appears that the policy is not intended to give rise to situations where the World Bank may be faced with having to deal with both a de facto government and a de jure government for the same member.

This World Bank policy sets out criteria for its staff to consider in relation to continuing existing loans or extending new loans to a

country with a “de facto government.”<sup>52</sup> The policy states at the outset that a “de facto government” is one that “comes into power, by means not provided for in the state’s constitution.”<sup>53</sup> The policy requires Bank staff to assess two different sets of criteria in determining the World Bank’s position. The first set of criteria applies to dealings with a de facto government with respect to disbursements under loans made by the Bank before the government assumed power. These criteria focus on the government’s effective control of the country and its recognition of prior obligations. The second set of criteria are more stringent and apply to dealings with a de facto government when considering whether to extend new loans to the government. Under the second set of criteria, the Bank first allows a certain time to pass so that it can weigh various factors such as the legal and political risks associated with transacting with the de facto government, the recognition of the government by a number of countries (particularly neighboring countries), and the position of other international organizations toward the government.

That said, in the recent case of Iraq, however, press reports indicate that the Bank’s position with respect to the Iraqi authorities after June 2004 was not predicated on an application of this operational policy on “Dealings with De Facto Governments.” The Bank’s director for the Middle East is reported to have informed the Bank’s Executive Directors that “[f]ollowing UN Security Council resolution 1546, we determine that there is now a *de jure* government in Iraq.”<sup>54</sup>

### **Implications Arising from the Recognition of Governments in International Organizations**

One possible reason for the difference in recognition criteria between international organizations is that the implications of recognition vary significantly between the organizations. Theoretically, in virtually all international organizations, questions of recognition should affect matters relating to the country’s representation in the organization, exercise of the country’s membership rights in the organizations (including voting rights), and both the undertaking and discharge of the country’s membership obligations.

However, in some organizations the practical implications of recognition might be limited to affecting the ability to attend meetings or to address the organization on behalf of a member country, while in

other organizations, recognition could also have major financial implications for both the organization and the member country.

Further, the magnitude of these implications could also vary significantly. For example, the financial implications arising from recognition may relate only to the payment of membership dues in one organization, while in another international organization, such financial implications could affect the provision and repayment of multi-million dollar loans.

The practical implications of controversies surrounding the recognition of a government were demonstrated over a protracted period in connection with Poland's membership in the International Civil Aviation Organization (ICAO). In 1945, the Polish authority based in London was recognized by the majority of the ICAO's membership as the government of Poland. This entity ratified the ICAO convention in 1945. The regime in Warsaw did not recognize the ratification and subsequently refused to pay the resulting contributions. When the authority in Warsaw was subsequently recognized by the ICAO's members as Poland's government it submitted a fresh application for membership. This application was rejected on the ground that Poland was already a member of the ICAO. Polish delegates from the Warsaw government were admitted but their voting rights were suspended in 1952, because Poland's subscriptions to the ICAO were in arrears. A settlement was finally reached only after five years, and in 1957 Poland paid part of the dues and had its voting rights restored.<sup>55</sup>

## **The IMF**

### **Dealings with an Entity as a Member Government in the IMF**

In the past, the decision to deal with governments in the IMF has normally been determined as an operational matter by its Managing Director and staff. Only rarely have difficult questions arisen that have had to be referred to the Executive Board or the Board of Governors.<sup>56</sup> While the IMF does not have a formally documented operational policy on dealing with an entity as a member's government, the consistent application of past IMF practice in the area renders the absence of such a document moot.

The IMF's practice indicates that in arriving at a recommendation IMF staff have approached the issue in stages. As stated earlier, the application of these stages only arises when there has been an extra-constitutional change in a member's government, that is, due either to internal power struggles or to foreign occupation.

In cases of internal power struggles such as coups d'état, IMF staff have followed the views of the international community even if this results in not dealing with any authority as a member country's government.<sup>57</sup> If there is no clear guidance from the international community, staff will determine whether a majority of IMF members (in terms of voting power) recognize or deal with the authority as a government in their bilateral relations. In such cases, a variety of relevant acts and declarations would reflect the views of the IMF member countries—for example, statements made in discussions before other international organizations, positions taken on the issue, and bilateral dealings that may otherwise evidence recognition.<sup>58</sup>

There may be situations in which the IMF has to resolve the issue of whether an entity is to be dealt with as a member's government before the views of the majority of IMF members (according to voting power) have been manifest. In such limited circumstances staff have recommended dealing with the entity in effective control of the country until such time as the views of the of the IMF's members are determined.

The use of this criterion is not without risk. In one instance, the Board of Governors ultimately decided to deal with the authority in exile, rather than the authority in effective control, as the member country's government. This happened in the case of Haiti, following the 1991 coup, when IMF staff recommended that the IMF deal with the government that exercised effective control over the country. This recommendation was made because the IMF had to address the issue at a time when the international community's views on whether there was a government in Haiti were not clear. However, during the 1992 annual meetings of the Bank and IMF, the Chairman of the IMF's Board of Governors, acting on the advice of the Joint Procedures Committee, accepted the credentials of the Haitian government in exile. The advice of the Joint Procedures Committee was based on the broad support of the IMF's membership. Therefore, following the Chairman's action all IMF relations were required to be conducted

with the government in exile, including informing the government in exile of its responsibility for the prompt discharge of Haiti's overdue obligations to the IMF. This incident only emphasizes the principle that the IMF's practice has been to reflect the views of the international community, including the majority of its membership (according to voting power) when addressing questions relating to dealing with a member's government.

While the above practices apply to changes in government for extra-constitutional reasons that are of an internal nature, they do not apply when the cause of the change is external. During the foreign military occupation of an entire country, the effective control criterion clearly cannot apply. This is because the international laws and usages of war provide that the status of a foreign state with effective control over a territory is that of an "occupant" or an "occupying power" and this status is distinct from that of a government.<sup>59</sup> In such cases, the international community may choose not to deal with any government or it may choose to deal with a government in exile, if there is one. The same issue arises in cases of annexations that are not recognized by the international community.<sup>60</sup>

Accordingly, in cases of foreign occupation, the IMF's only criterion is whether the international community, including at least a majority of IMF members (according to voting power), deal with an entity as the country's government in their bilateral relations. On the operational aspects, it is useful to note that generally the IMF's Executive Directors (and the Board of Governors) have supported the recommendations of the Managing Director and IMF staff. However, as previously indicated, there has been one exception.

### **Implications Arising from Dealing with an Entity as a Member Government in the IMF**

The question that remains to be answered is whether dealing with an entity as a member's government in the IMF implies that the entity is then automatically entitled to exercise all rights and incur any obligations on behalf of the member in the IMF. While dealing with an entity as a member government is clearly a necessary condition for that government to exercise rights in and incur obligations to the IMF, it may not be a sufficient condition. The sufficiency of the condition

has to be tested against other provisions in the IMF's Articles of Agreement and in IMF policies related to the right or obligation in question.

For instance, dealing with an entity as a member government would generally be both necessary and sufficient for the government to exercise the right to appoint the member's Governor and an Alternate Governor to the IMF, or participate in the election of Executive Directors.<sup>61</sup> On the other hand, it would only be a necessary condition, that is, not a sufficient condition, for the entity to have access to IMF resources. This is because provisions in the IMF's Articles and its policies contain additional conditions that must be met for the IMF to provide financial assistance (e.g., the requirement to adequately safeguard IMF resources when providing financial assistance). These conditions vary depending on the level of access sought and the policy under which access is contemplated.

In addition to affecting issues surrounding the exercise of rights and the incurring of obligations, recognition also affects the resolution of issues related to the performance of certain obligations of membership, the attribution of responsibility for nonperformance of those obligations, and related issues of sanctions.

Under the IMF's Articles of Agreement, the performance of nonfinancial obligations—for example, the provision of information or the avoidance of exchange restrictions—typically requires specific actions or forbearance by the member country. If the government of a member has no control over its territories or when there is no government or when the country is under foreign occupation, the member cannot be responsible for breaches in the performance of these obligations. However, financial obligations, such as those arising out of outstanding purchases or loans or a negative position in the IMF's Special Drawing Rights Department, can continue to accrue against a member without any act or forbearance by the member. Therefore, these obligations are unaffected by the presence or absence of a government.

In any event, sanctions for failure to meet membership obligations have not been imposed on a member that has no government. One of the reasons is that the IMF's procedures for the imposition of sanctions require an invitation to the member to be represented at the

meeting of the IMF where sanctions are considered.<sup>62</sup> If there is no government, such meetings cannot be held.

### **Conclusion**

Certain general conclusions may be drawn from the above review of IMF law and practice. Clearly, questions with regard to dealing with governments in the IMF only arise in cases of extra-constitutional changes to a member country's government. The resolution of these questions depends initially on whether the change is internal (e.g., coups d'etat) or external (e.g., foreign occupation). However, in both cases the resolution is closely linked to the views of the international community, including, in particular, the IMF's membership.

Further, the decision to deal with an entity as a member's government is based on the total evidence of the international community's dealings and relations with that entity, including evidence of IMF members' bilateral dealings and relations with the entity. Therefore, situations cannot arise in which IMF members (or at least a majority according to voting power) deal with an entity as a government for IMF purposes only, but do not deal with the same entity as a government in their own bilateral or other relations.

The IMF's past practice has not been to deal with an entity as a government for some purposes but not for others. This is particularly important because dealing with an entity as a member country's government is a necessary condition for the entity to exercise the member's right in the IMF or for the entity to incur international obligations associated with membership in the IMF. At the same time, such action may not be a sufficient condition because of other provisions in the IMF's Articles and relevant IMF policies.

## Notes

<sup>1</sup> Malcolm N. Shaw, *International Law* (New York: Cambridge University Press, 1997) at 303.

<sup>2</sup> Throughout the discussion the terms “country” and “state” are used interchangeably. Although some legal commentators prefer the term “state,” the term “country” is used in the IMF’s Articles of Agreement.

<sup>3</sup> See *U.S. Restatement (Third) of Foreign Relations Law* § 203, comment a (1987) [hereinafter “3d *U.S. Restatement*”].

<sup>4</sup> See, e.g., Marjorie Whiteman, *Digest of International Law*, Vol. 2, at 1–132 (1963). See also Ian Brownlie, *Principles of Public International Law* (Oxford: Oxford University Press, 1998) at 86–89.

<sup>5</sup> A good example of an issue that arises in both discussions, and one that is substantively beyond the scope of this chapter, is whether recognition in international law is constitutive (i.e., creates a legal status) or declaratory (i.e., merely acknowledges the existence of such status).

<sup>6</sup> See, e.g., Whiteman, *supra* note 4, at 119–241 (discussing examples concerning the recognition of countries) and 242–485 (discussing examples concerning the recognition of governments); and Brownlie, *supra* note 4, at 91 (stating that although “recognition of government and state may be closely related, they are not necessarily identical”).

<sup>7</sup> The importance of this distinction is not restricted to legal issues—it is also critical to considering economic policy issues from a political perspective. See, e.g., Bimal Jalan, *The Future of India: Politics, Economics and Governance* (New York: Viking, 2005), at 4–5 (suggesting that the conceptual distinction between governments and countries is vital because it explains the basis for the accountability of governments).

<sup>8</sup> See, e.g., 3d *U.S. Restatement*, *supra* note 3, § 203 (stating that one country is required to treat a regime in effective control of another country as the government of that other country unless such control has been effected by the threat or use of armed force in violation of the UN Charter).

<sup>9</sup> See Brownlie, *supra* note 4, at 91.

<sup>10</sup> See Whiteman, *supra* note 4, at 68.

<sup>11</sup> Shaw, *supra* note 1, at 310. See also Brownlie, *supra* note 4, at 91 (“everything depends on the intention of the recognizing government and the relevant circumstances”); and Whiteman, *supra* note 4, at 48 (“recognition is



largely a matter of intent on the part of the recognizing government and cannot be lightly imputed”).

<sup>12</sup> See Shaw, *supra* note 1, at 253. See also *3d U.S. Restatement, supra* note 3, § 203.

<sup>13</sup> Some earlier scholars, like Lauterpacht and Guggenheim, adopted the view that there is a legal duty to recognize. However, this standpoint has been vigorously criticized; not least because it bears no relation to state practice. See Brownlie, *supra* note 4, at 90.

<sup>14</sup> See generally Whiteman, *supra* note 4, at 5–18.

<sup>15</sup> See, e.g., *Latvian State Cargo & Passenger S.S. Line v. Clark*, 80 F. Supp. 683, 684 (stating that questions “of recognition or non-recognition of foreign governments are beyond the reach of the courts”); and Brownlie, *supra* note 4, at 89 (stating that questions of recognition or non-recognition are political both in the sense of being voluntary and in the sense of not having to rest on any legal basis at all).

<sup>16</sup> See M. J. Peterson, *Recognition of Governments: Legal Doctrine and State Practice, 1815–1995* (New York: St. Martin’s Press, 1997), at 52.

<sup>17</sup> The controversy over imputing legitimacy to governments became quite contentious during the middle of the last century with conflicting doctrinal positions, espoused by two Latin American statesmen, at the center of the debate. On the one hand, the *Tobar doctrine* contended that no country’s government resulting from a revolution or coup should be recognized until that country’s people have established its constitutional legitimacy. On the other hand, the *Estrada doctrine* contended that one country could not pass judgment on the legal capacity of another country’s government as this was derogatory to the dignity and sovereignty of the other country. Instead, a government, at its sole discretion, should simply maintain or recall its diplomatic representatives to another country and accept accreditation of that other country’s representatives. See Whiteman, *supra* note 4, at 84–89.

<sup>18</sup> See, e.g., [1974] *Digest of U.S. Practice in International Law* 13 (stating that the U.S. State Department’s repeated response to queries on the issue was “The question of recognition does not arise: we are conducting our relations with the new government”). Similar practices have been followed by many other countries since the 1980s, for example, Australia, Belgium, Canada, France, the Netherlands, New Zealand, and the United Kingdom. See also Shaw, *supra* note 1, at 307; and Stefan Talmon, *Recognition of Governments in International Law: With Particular Reference to Governments in Exile* (Oxford: Oxford University Press, 1998), at 275–85 (setting out

responses received to questions on recognition practices from The Bahamas, Belgium, Bolivia, Dominica, Finland, Ghana, Greece, Iran, Italy, New Zealand, Solomon Islands, Sri Lanka, and Switzerland).

<sup>19</sup> See, e.g., *3d U.S. Restatement*, *supra* note 3, § 203, comment b (stating that treating “a regime as a government includes accepting its acts as creating international rights and obligations; it does not require according to the regime the prerogatives commonly accorded to recognized governments, for example the right to sue in domestic courts”).

<sup>20</sup> See, e.g., *Luther v. Sagor* [1921] 3 K.B. 532 (referring to the U.K. Foreign Office recognizing the Soviet government as the de facto government of Russia in 1921); and *The Arantzazu Mendi* [1938] 4 All E.R. 267 (referring to the U.K. Foreign Office recognizing the Nationalists under General Franco “as a Government which at present exercises de facto administrative control over the larger portion of Spain”).

<sup>21</sup> Brownlie, *supra* note 4, at 92.

<sup>22</sup> See also John Basset Moore, “The New Isolation,” *27 American Journal of International Law* 607 (1933) (stating that the accreditation of diplomatic representatives to the de jure or de facto government of any country would “savor of burlesque”). Cf. Shaw, *supra* note 1, at 308 (stating that there are “few meaningful distinctions between a de facto and a de jure recognition, although only a government recognized de jure may enter a claim to property located in the recognizing state”).

<sup>23</sup> Such diplomatic status may be accorded by the recognition of an envoy as a representative of the government of the country, by the grant of related diplomatic privileges and immunities to such functionaries, or by entering into agreements with the authority acting on behalf of the country it represents. See Shaw, *supra* note 1, at 255.

<sup>24</sup> See, e.g., *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (demonstrating that while the United States recognizes the Castro regime as Cuba’s government, it has not maintained diplomatic relations with Cuba’s government since 1961).

<sup>25</sup> For instance, a British consul has operated in Taiwan, but the United Kingdom does not recognize the Taiwanese government. See Shaw, *supra* note 1, at 311.

<sup>26</sup> Ian Brownlie, “Recognition in Theory and Practice,” *53 British Yearbook of International Law* 197 (1982).

<sup>27</sup> See Brownlie, *supra* note 4, at 86 (emphasis in original). See also Shaw, *supra* note 1, at 312 (stating that “all the relevant surrounding circumstances will have to be carefully evaluated before one can deduce the intention to extend recognition”); and Whiteman, *supra* note 4, at 48 (stating that recognition cannot be imputed lightly).

<sup>28</sup> Cf. *Haile Selassie v. Cable and Wireless Ltd (No. 2)* [1939] 1 Ch. 182 [hereinafter “*Haile Selassie*”] (determining an entity’s legal rights as a foreign government before English courts, in circumstances where evidence available indicated the simultaneous recognition of different *de jure* and *de facto* governments for Ethiopia).

<sup>29</sup> See Talmon, *supra* note 18, at 118 (1998); and Shaw, *supra* note 1, at 251.

<sup>30</sup> See, e.g., Article 10, para. 1, *Draft Articles on State Responsibility for Internationally Wrongful Acts*, Annex to UN Doc. A/Res/56/83 (January 28, 2002) (stating the “conduct of an insurrectional movement which becomes the new government of a State shall be considered an act of that State under international law”).

<sup>31</sup> See, e.g., *The Arantzazu Mendi*, *supra* note 20.

<sup>32</sup> See, e.g., *3d U.S. Restatement*, *supra* note 3, § 205 (1) (stating that “a regime not recognized as the government of a state, is ordinarily denied access to courts in the United States”).

<sup>33</sup> See *id.* § 205 (2) (stating that “a regime not recognized as the government of a state, is not entitled to property belonging to that state located in the United States”); and *Haile Selassie*, *supra* note 28 (stating that only the recognized *de jure* government had access to Ethiopia’s property located in the United Kingdom).

<sup>34</sup> Brownlie, *supra* note 4, at 97.

<sup>35</sup> See *supra* notes 17–19 and accompanying text.

<sup>36</sup> These distinctions raise an interesting question. Many authors state that the recognition of governments is a “subjective concept,” i.e., based on discretion. See, e.g., Talmon, *supra* note 18, at 14; and Whiteman, *supra* note 4, at 6. Clearly this is true in the case of recognition of governments by other governments. However, it is questionable whether such subjectivity is legally tolerable in the case of international organizations, to the extent such organizations are required to be neutral.

<sup>37</sup> See Talmon, *supra* note 18, at 175.

<sup>38</sup> See Henry G. Schermers and Niels M. Blokker, *International Institutional Law* (Boston: Kluwer Law International, 1995), at 177–86.

<sup>39</sup> UN Doc. A/Res/5/396 (December 14, 1950).

<sup>40</sup> *Id.* In General Assembly discussions on recognition of governments, member delegations have used arguments based on the authorities' effective control and arguments concerning the authorities' legitimate right to represent the member state. See Schermers, *supra* note 38, at 179.

<sup>41</sup> See Joseph Gold, *Membership and Non-Membership in the International Monetary Fund* (Washington: IMF, 1974), at 66 (stating that the resolution “does not purport to declare that the attitude of the General Assembly on a disputed question of representation would bind the specialized agencies, of which the [IMF] is one”).

<sup>42</sup> On occasion, Security Council resolutions have “recognized” an entity as a UN member country's government (see, e.g., UN Security Council Resolution No. 1453 (2002), *adopted on* December 24, 2002, recognizing the “Transitional Administration as the sole legitimate Government of Afghanistan”) or called on countries to “not recognize” an entity as a government (see, e.g., UN Security Council Resolution No. 661 (1990), *adopted on* August 6, 1990, calling on countries to not recognize any regime in Kuwait established by the occupying power). In this connection, it should be noted that while Security Council resolutions are binding on UN member states, if taken under Chapter VII of the UN Charter, such resolutions are not binding on the IMF, which, as an independent international organization, is only required to have due regard for Security Council resolutions under Articles 41 and 42 of the UN Charter. See *Agreement between the United Nations and the International Monetary Fund*, Articles I and VI, *reprinted in* IMF, *Selected Decisions of the International Monetary Fund*, Twenty-Eighth Issue (Washington: IMF, 2004), at 749.

<sup>43</sup> See WHO Docs. A46/41, A46/44, and A46/51 (1993). The World Health Organization (WHO) decision to recognize the credentials presented by both delegations has been criticized and found to be “highly unsatisfactory” from both a legal and practical standpoint as it did not resolve the issues of which delegation was to exercise Zaïre's vote or represent Zaïre on WHO committees. See Schermers, *supra* note 38, at 181.

<sup>44</sup> International Labor Organization, *Second Report of the Credentials Committee*, Provisional Record No. 14, 80th Session—June 1993.

<sup>45</sup> See UN Doc. A/48/512 (December 21, 1993).

<sup>46</sup> See, e.g., Gold, *supra* note 41, at 61 (stating that a “distinction must be observed between questions of the recognition of governments and problems of the credentials of delegations attending meetings”).

<sup>47</sup> See, e.g., Schermers, *supra* note 38, at 1162–63. Cf. *supra* note 44.

<sup>48</sup> Report of the Credentials Committee, UN Doc. A/58/625 (December 11, 2003), para. 5 (listing Iraq among the UN member countries that submitted credentials in due form).

<sup>49</sup> CPA/Reg/13 July 2003/06, section 1.

<sup>50</sup> World Bank Operational Policies, *Dealings with De Facto Governments*, OP 7.30, July 2001. The World Bank’s operational policies are “prepared for use by World Bank staff and are not a complete treatment on the subject.” *Id.*

<sup>51</sup> *Id.*, para. 2.

<sup>52</sup> The policy defines loans to include both credits and grants. *Id.*, n. 1. However, it is unclear whether the policy applies to other dealings between the World Bank and a member country’s authority that has come into power by extra-constitutional means (e.g., nonfinancial dealings such as participation in the election of Executive Directors to the World Bank’s Executive Board).

<sup>53</sup> Again, it is not obvious that every situation in which an authority comes into power by means not provided by the country’s constitution triggers application of the policy.

<sup>54</sup> “World Bank Says Recognizes Iraq Interim Government,” Reuters, June 29, 2004.

<sup>55</sup> See Schermers, *supra* note 38, at 1163.

<sup>56</sup> See Gold, *supra* note 41, at 61.

<sup>57</sup> For example, in the case of Somalia in 1992, IMF staff followed the practice of the international community and recommended not recognizing any authority as the government of Somalia.

<sup>58</sup> In 1975, IMF staff recommended dealing with the Provisional Revolutionary Government of the Republic of South Vietnam on the basis that a substantial number of members of the IMF with a substantial portion of the total voting power of the IMF had recognized the Provisional Revolutionary Government of the Republic of South Vietnam.

<sup>59</sup> See 1907 Hague Convention (IV) Respecting the Laws and Customs of War on Land, Annex to the Convention, Article 43; and 1949 Geneva Convention (IV) Relative to the Protection of Civilian Persons in Time of War.

<sup>60</sup> For instance, in 1990–91 the attempted annexation of Kuwait by Iraq was not recognized by the international community, and Kuwait was regarded as a state that was illegally occupied by a foreign power and represented by its government in exile.

<sup>61</sup> See IMF, *Articles of Agreement of the International Monetary Fund*, Article XII, <http://www.imf.org/external/pubs/ft/aa/index.htm>. However, the sufficiency of this condition would not exist in a situation in which the member's voting rights have previously been suspended (pursuant to Article XXVI of the IMF's Articles of Agreement).

<sup>62</sup> See IMF, *Articles of Agreement of the International Monetary Fund*, Article XXVI, <http://www.imf.org/external/pubs/ft/aa/index.htm>, and IMF, *By-Laws Rules and Regulations of the International Monetary Fund*, Fifty-Ninth Issue, Sections 19 and 22, <http://www.imf.org/external/pubs/ft/bl/blcon.htm>.

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## **II. CENTRAL BANKING ISSUES**

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**The Three Pillars of Central Bank  
Governance: Toward a Model  
Central Bank Law or a Code of Good  
Governance?**

FABIAN AMTENBRINK

In recent years, the role that central banks play in the economy and their position within or outside government structures have been the focal point of numerous contributions, mainly by economists and lawyers but also by political scientists. This may be not only due to the fact that the tasks that central banks fulfill have changed dramatically, but also a consequence of the increased attention paid to the broad approaches to economic policy and the role that central banks fulfill in this regard. Central bank systems have been scrutinized systematically with regard to their institutional structure in search of the ideal arrangement from both an economic and a legal point of view. Adding to this has been the more recent discussion on *good governance* as a means to facilitate macroeconomic stability, orderly economic growth, and a stable regulatory environment. Central banks are thought to play a vital role in achieving these goals to the extent that the legal framework in which they operate reflects good governance.<sup>1</sup> As Lybek has pointed out: “Good central bank governance means that the objectives and tasks delegated to an institution are performed effectively and efficiently, thus avoiding misuse of resources, which is crucial for establishing a good track record.”<sup>2</sup>

This chapter identifies a number of principles that arguably should form the basis for the good governance of central banks, and identifies their impact on the institutional structure of a central bank. If it is accepted that the legal framework of a central bank should be based on these principles, the question arises whether and to what extent they can and should form the basis for a model central bank law.

Throughout the discussion emphasis is placed on institutional, rather than operational, considerations and legal, rather than economic, considerations. While the importance of the economic dimension of central bank governance is acknowledged, given the many facets of this dimension, it is not possible to address it within the context of the present discussion. Given the broad institutional approach to central bank governance chosen for this discussion, issues more closely related to what may be summarized under the term “corporate governance” are also outside the scope of this chapter.<sup>3</sup> Finally, while many observations made herein have implications for all areas of operations of a central bank, in principle this discussion focuses on the arrangements surrounding the primary task of central banks, that is, the conduct of monetary policy.

### **The Three Pillars of Central Bank Governance**

Central bank governance is arguably defined by a number of key concepts or pillars, which together should form the basis of the legal framework governing a central bank and on which central bank governance should rest—that is, independence, democratic accountability, and transparency. While these concepts are in the first instance introduced separately this is not to say that they should be considered in isolation. In fact, as will be highlighted later in the discussion, the three pillars are intertwined and in some instances positively or negatively correlated.

#### **Central Bank Independence**

While central bank independence is still one of the most discussed institutional features of a central bank in economic and legal literature, it may be concluded that there exists a large consensus basically accepting the need for central bank independence. Indeed, in recent years an increasing number of countries have released their central banks into independence or strengthened the existing degree of independence. In the European context this has been promoted by the establishment of an Economic and Monetary Union (EMU) along with legal requirements that member states of the European Union have to meet with regard to the institutional structure of their respective central banks in order to qualify for participation in the euro zone.<sup>4</sup> Numerous economic studies have set out to establish

the economic benefits of central bank independence and in particular its impact on inflation and inflation variability as well as growth and growth variability.<sup>5</sup>

The basic argument is that elected politicians face monetary temptations conflicting with an inflation-averse monetary policy. The very nature of their position, being based on the mandate of the electorate, makes it impossible for politicians to be impartial to the short-term benefits of an expansive monetary policy. Politicians may also lack the qualifications of experts in the field. By leaving it to the discretion of an independent central bank to conduct monetary policy, the focus can be on long-term stability rather than short-term monetary temptations.<sup>6</sup> Some promoters of central bank independence even go so far as to argue that a central bank should in fact be a separate, fourth branch of government that can check potentially damaging policies of other government branches.<sup>7</sup> And indeed in some instances central banks may have taken on this role voluntarily, such as in the case of the European Central Bank.<sup>8</sup>

Despite the overall convincing economic case for independence it is nevertheless important to always keep in mind that a universal legal theory, according to which a central bank charged with the conduct of monetary policy has to be independent, does not exist. Rather, central bank independence may be required as a feature of the institutional structure of a central bank in order to ensure the effective conduct of monetary policy.

Both legal and economic studies on central bank independence focus primarily on the evaluation of the institutional settings of the central banks and their relationship with the executive and legislative branches of government. Different aspects of independence are classified under headings such as institutional, functional, organizational, and financial independence.<sup>9</sup>

### **Central Bank Accountability**

The second pillar of central bank governance is democratic accountability. As has been set out elsewhere, the need for mechanisms of democratic accountability derives from both the legal nature of a central bank and its position within a democratic system,

as well as the task that a central bank usually fulfills with regard to monetary policy.<sup>10</sup>

It may be considered a common feature of all central banks, which do not form an integral part of the executive branch of government, that they fall outside the classical three-branch system of government, or *trias politicas*, and its system of checks and balances. The latter forms an important element in the legitimation of and the accountability for the power delegated to these branches. From a normative point of view, the need for mechanisms of democratic accountability derives from the special position that the central bank has vis-à-vis the democratically elected legislative and the executive branches. To the extent that central banks are independent, mechanisms of democratic accountability are required in order to legitimize the position of the central bank within a given constitutional system. Central banks do not operate in a constitutional vacuum nor should they.

From a more functional point of view it can be observed that despite its importance, monetary policy in principle forms part of economic policy and should thus ultimately be given similar consideration as other elements of economic policy when it comes to the requirement of democratic accountability.<sup>11</sup> Indeed, a central bank does not hold a neutral position within the system of government. Since the executive delegates functions to the central bank, the accountability of executive activity through the institutions of the legislative branch is narrowed. While the initial act of delegation of monetary policy to a central bank through an act of parliament arguably legitimizes the position of a central bank in a given constitutional system, this cannot justify the absence of mechanisms of democratic accountability.<sup>12</sup>

To be sure, a situation in which a central bank operates under executive control is not only likely to deteriorate the performance of the tasks performed by the central bank for the reasons explained above, but such a situation also does not remove the need for mechanisms of democratic accountability. Rather than merely providing for adequate mechanisms in the institutional setup of the central bank, the government itself has to be accountable for its control over the central bank.

It has been argued that independent central banks constitute a democratic self-restraint by the democratically legitimized legislative branch, which recognizes its own tendency to (ab)use monetary policy for its own political ends.<sup>13</sup> The logic behind this argument seems to be that central bank independence provides monetary stability, which in turn is a necessary condition for a stable democracy. The implication of this school of thought is far reaching indeed as monetary stability seems to be viewed as an essential precondition of democracy. From this hypothesis it is only a small step to elevate central bank independence to the ranks of a democratic principle.<sup>14</sup> Yet, it is far from self-evident that the absence of a system of checks and balances could actually promote or stabilize a democratic system.

It is true that the case for central bank democratic accountability is based on the assumption that central banks operate in a democratic system featuring a basic separation of powers and a system of checks and balances. Where countries lack some or all of these prerequisites, making central bank independence subject to the development of democratic institutions may actually turn out to be counterproductive.<sup>15</sup> Indeed, it could be argued that the introduction of central bank independence and some (lesser) mechanisms of accountability to non-majoritarian systems will still have the potential of enhancing democracy, as it may result in a more stable economic environment, arguably creating an atmosphere in which democratic structures are given a chance to develop. However, at the same time it has been suggested that central bank reforms have also been used by conservative authoritarian regimes in the past to insulate the central bank from undesired public scrutiny in the wake of a transition to democratic rule.<sup>16</sup>

There are various ways in which mechanisms of accountability can form part of the legal basis of central banks, and different elements have been identified as contributing to such.<sup>17</sup> Interestingly, in many instances they refer to the same institutional features of a central bank, which are examined in the context of central bank independence, such as the way in which the bank conducts monetary policy and the relationship of the central bank with the executive and legislative branches of government.<sup>18</sup>

## Central Bank Transparency

In the course of the discussion on democratic accountability, transparency has emerged as yet another key feature of the way in which central banks operate.<sup>19</sup> Indeed, while the traditional view has been that at least some of the tasks assigned to central banks can best be achieved outside the limelight, in more recent times central banks have discovered transparency as an ally both in meeting demands of more openness and accountability and in communicating monetary policy. In the words of Posen it may be observed that “central bank transparency has gone from being highly controversial to motherhood and apple pie.”<sup>20</sup> Together with central bank independence and accountability, transparency forms the third pillar of central bank governance.

Despite its common usage it is not always very clear what central bank transparency amounts to. Basically, two definitions of transparency can be distinguished in the policy-oriented literature on central bank transparency. First, central bank transparency is referred to as the activities of the central bank in providing information. Thus, for example, Lastra defines transparency as the degree to which information on policy actions is available.<sup>21</sup> A second, somewhat broader, approach to transparency includes the public’s understanding of the decisions taken by the monetary authorities and the reasoning behind them.<sup>22</sup>

Arguably, the role of transparency in central banking may be twofold. First, transparency functions as a precondition for accountability. In the words of Deane and Pringle, “an open democratic society has the right to demand a broad degree of understanding of what central banks do and how they do it.”<sup>23</sup> Through institutional arrangements ensuring the transparent conduct of central bank activities, those institutions charged with evaluating the performance of the central bank gain the necessary information that facilitates evaluations being made on a reliable basis. As Day and Klein have observed, “effective scrutiny implies effective access to information.”<sup>24</sup>

It is with regard to transparency that the International Monetary Fund (IMF) has already made an important contribution to defining

central bank governance. In the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies<sup>25</sup> a broad approach is taken to the notion of central bank transparency, referring to it as

an environment in which the objectives of policy, its legal, institutional, and economic framework, policy decisions and their rationale, data and information related to monetary and financial policies, and the terms of agencies' accountability, are provided to the public on an understandable, accessible, and timely basis.<sup>26</sup>

At the same time, it may somewhat overstretch the potential of transparency as a pillar of central bank governance if these information requirements are summarized as "broad modalities for accountability for the conduct of monetary policy."<sup>27</sup> Transparency by itself cannot provide for a sufficient degree of democratic accountability and, thus, cannot serve as a substitute for other mechanisms of accountability. Transparency as a constraining mechanism is overestimated by those observers, who assume that, once provided with sufficient information, the financial markets provide an adequate mechanism of accountability in the form of a loss of credibility of the central bank in case of poor performance.<sup>28</sup> As observed by Posen the claim that central bank transparency provides sufficient accountability for central banks in democratic societies is misleading.<sup>29</sup> The mere fact that a central bank has to conduct monetary policy in a transparent manner, at best, results in the availability of the information necessary in order to evaluate the bank's performance.

Consumers of this information are not only governments but also the general public. The latter's perception of what the central bank does and how it is done may have an impact on the performance of the central bank. Put differently, insulating the central bank from outside influence and providing it with a clear set of (monetary policy) objectives may not, by itself, be sufficient to ensure the success of the bank in performing the tasks assigned to it, as transparency may form a vital component of an effective monetary policy.<sup>30</sup>

In identifying the features describing a transparent central bank the main focus lies with the conduct of monetary policy, an area that



has already been identified in the context of central bank independence and accountability where it plays a similarly important role.<sup>31</sup>

### **Good Governance in the Conduct of Monetary Policy**

Each of the three pillars of central bank governance deserves to be observed in its own right for the reasons stated above. Arguably, the key to good governance in this regard lies in the combined application of these principles in designing the legal framework of a central bank. As it has become clear that the same central bank features are consulted in order to implement the respective element, observing all three pillars becomes a balancing act. The conduct of monetary policy forms the primary task of a central bank. Hence, institutional arrangements ensuring good governance must first and foremost relate to this function. Moreover, the three pillars take center stage in the relationship between the central bank and the executive and legislative branches of government.

### **Monetary Policy Formulation and Communication**

It is monetary policy that central bank independence is primarily geared toward. Institutional independence first of all refers to the central bank's power to formulate monetary policy independently from political institutions. Moreover, it may also refer to a central bank's freedom to set the final goals of monetary policy. This is also sometimes referred to as *political* or *goal* independence.

From the point of view of accountability, a yardstick is needed for the body charged with holding the bank accountable in order to determine whether the central bank has discharged its duties in a satisfactory manner. Indeed, without a yardstick, an assessment of the central bank's performance is either impossible or able to be based only on variables most likely in the form of political considerations, which will not serve accountability. Both the monetary policy objective of a central bank as well as its projections on monetary policy and quantified intermediary targets can form the basis for such a yardstick.

The existence of an explicit and clear legal mandate for the central bank has to be considered an important feature of all three

pillars of central bank governance. A clear monetary policy objective reduces the risk of political pressure and open conflicts between government and the central bank,<sup>32</sup> while at the same time ensures that the central bank does in fact follow an inflation-averse monetary policy.<sup>33</sup> Central banks charged with multiple objectives face policy choices that may require putting aside the objective of price stability.<sup>34</sup> A single objective may be politically difficult to defend. However, in the case of multiple objectives there should be a clear hierarchy of objectives stated in the central bank law. When this is left to the central bank to decide, the real objectives of monetary policy may be opaque and, moreover, subject to unsolicited influence.

The classic example for a central bank featuring multiple objectives is the U.S. Federal Reserve System (Fed). Here the actual objective of monetary policy can only be construed from central bank announcements. The European Central Bank (ECB) is an example of a system that includes a clear prioritization, since the bank is only allowed to support the general economic policies in the European Communities if and to the extent that this does not interfere with the primary objective of the ECB, that is, price stability.<sup>35</sup> However, the value of a secondary objective may be limited. The central bank may interpret the primary objective, for example, price stability, in such a way that it effectively excludes steering monetary policy toward a secondary objective, in particular if the secondary objective is broad and largely undefined, such as in the case when the legal basis refers to the supporting of the general economic policy. In such an arrangement the central bank may very well effectively ignore the secondary objective, by arguing that this objective can best be achieved by pursuing the primary objective.<sup>36</sup>

Whether the monetary policy objective is directed toward price stability or another economic aggregate is secondary from the point of view of central bank governance, as long as it is quantifiable in a way that allows for the formulation of a point target or target range. Monetary policy objectives can range from broadly defined to quantified objectives. Broadly defined objectives may be considered the least useful in terms of providing a yardstick for the evaluation of the performance of the central bank. In such a setting the central bank not only has to decide whether and when to apply the monetary policy instruments, but also has to define the monetary objective and decide on the approach it takes in achieving this objective. In economic

terms the central bank has both instrument and goal independence. This has, for example, been established for the ECB. This is also the case, albeit to a lesser extent, in situations in which the legal basis fails to quantify the monetary objective, leaving it for the central bank to do so.<sup>37</sup> Taken to the extreme, this may be reflected as a legal basis that leaves it to the central bank to develop and define monetary policy objectives.

Where a central bank has both instrument *and* goal independence the body charged with holding the central bank accountable is not provided with an effective statutory yardstick to evaluate the performance of the bank.<sup>38</sup> While a quantification of the monetary policy by the central bank itself could theoretically also function as a yardstick for the evaluation of its performance, it is questionable whether these self-announced quantifications amount to concrete legal rules, in particular in the light of potential deviations.

Given the fact that economic circumstances change, it does not seem practical to provide for a quantification of the monetary policy objective in the legal basis itself. One possible arrangement, to be found at the Bank of England, is to provide for the executive government to define a monetary policy target, which the bank thereafter has to reach in conducting monetary policy independent from government. Another arrangement, which gives the central bank a greater influence in defining the monetary policy objective, is to be found in the so-called contract approach. Here the monetary policy objective is quantified in an agreement between the government and the central bank. Since it is the central bank that, in the end, has to meet the quantified monetary objective in implementing monetary policy, it will be in its vital interest to reach an agreement with the executive government that will include a realistic target. At the same time the executive government also commits itself to certain goals, making it more difficult for it to criticize the central bank for its conduct of monetary policy in accordance with what has been agreed. The contract approach has been implemented in the central bank systems of New Zealand and Canada, both of which require government–central bank agreements on monetary policy targets.<sup>39</sup>

The strategy of the central bank to reach the ultimate objective(s) should be transparent. A clear understanding by market participants

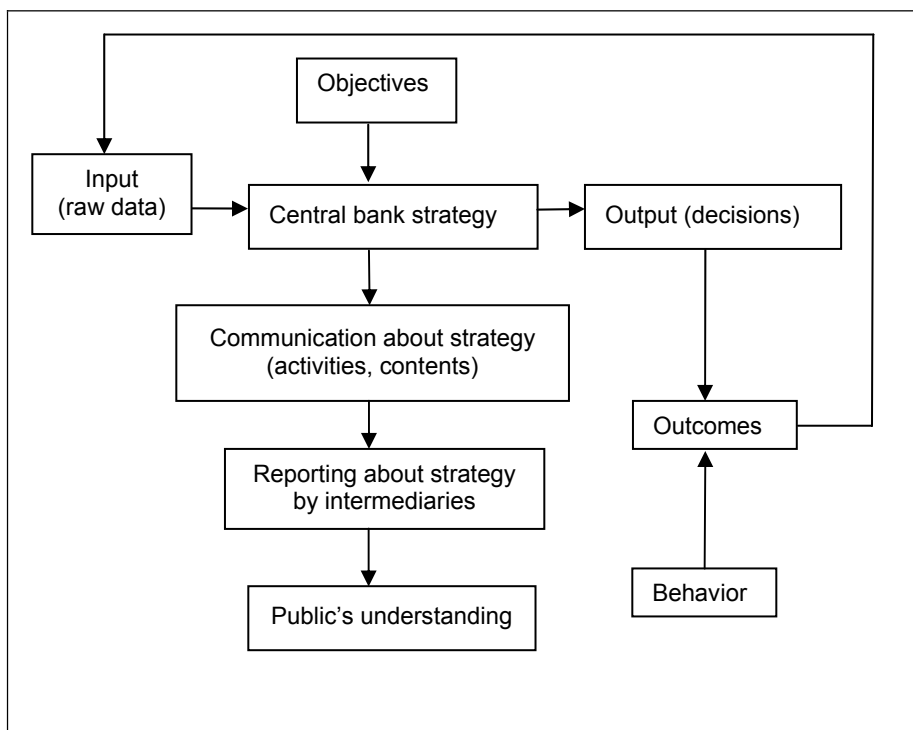
of the underlying framework on which central bank decisions are based will lead to a better understanding of the decisions taken. Market participants should know what the central bank has in mind when it sets interest rates and be able to clearly distinguish between the instruments of monetary policy and the operational target that is affected by the central bank's action, but which is ultimately determined by market forces. To this end, the bank should announce the monetary policy strategy and explain its monetary policy decisions.

An explicit mandate enhances not only accountability but arguably also the credibility of the monetary policy framework of the central bank and helps to avoid the perception or reality that the central bank conducts an overly conservative monetary policy.<sup>40</sup> The institutional setup of a central bank must ensure adequate communication of monetary policy to the outside world. The key to the understanding of this function of transparency is the interrelationship between central bank transparency and the public. As has been argued elsewhere, the effect of monetary policy on inflation and output growth (outcome) is determined not only by monetary policy decisions, but also by the expectations and the behavior of the public, based on their understanding of the bank's strategy. The outcome arguably influences the input used by the central bank, that is, raw economic data, which in turn influence the bank's decisions. The media, as intermediaries between the central bank and the general public, play a vital role in communicating the monetary policy strategy of the central bank to the general public and have a considerable influence on how the public understands the monetary policy pursued by the central bank as is shown in Figure 1.<sup>41</sup>

In facilitating the understanding of the general public regarding what the central bank does and does not do, publications and public statements can play a vital role. Press conferences and the publication of press releases can communicate the motivation for a certain policy decision. This also includes public access to the economic data underlying monetary policy decisions, such as money supply, inflation, GDP, and unemployment rates, as well as the announcement of the economic model(s) applied by the central bank. Moreover, the 1999 IMF Code has identified the public availability of the schedule of meetings of the policymaking body as a further element of

transparency, since it becomes clear when policy decisions will be taken.<sup>42</sup>

**Figure 1. Monetary Policy Strategy and Communication**



Openness in the decision-making process of the central bank can further add to the understanding of what the central bank does. This can be reached mainly through the publication of the minutes of the meetings of the monetary policy board. Retrospectively revealing potential differences in opinions on the monetary policy board not only assists in judging the performance of central banks—and even individual central bank officials—with regard to the adequacy of their assessments, but also educates a larger audience in understanding that monetary policy is a consequence of judgments based on more or less reliable economic data rather than an exact science.<sup>43</sup> Such an arrangement is of course far from undisputed, as it is often argued that the publication of such information could not only hamper free and

open discussions on the monetary policy board of the bank, but also influence monetary policy decisions by the central bank. With regard to the latter argument, the arrangement in the Bank of England Act provides a good example of how market-sensitive information can be excluded from immediate publication. The first argument may be one that is primarily directed at the European System of Central Banks (ESCB) and ECB and its particular structure, which includes the governors of the central banks participating in the euro zone on the Governing Council, the monetary policy board of the ECB. Here it is feared that the open process of deliberations could result in undesired pressure on the national central bank governors.

### **Relationship with Government**

In discussing central bank governance, the conduct of monetary policy arguably cannot be discussed without reference to the relationship with the executive and legislative branches of government.<sup>44</sup> The three pillars identified above should guide this relationship.

Advocates of central bank independence argue rightly that the status of the central bank as an institution should be separate primarily from the executive, but also from the legislative power, that is, parliament.<sup>45</sup> A central bank that forms part of the executive branch of government, for example, the Treasury, lacks institutional independence, which may result in a suboptimal monetary policy.

The legal basis of the central bank and its position in the overall constitutional system in which it is located play an important role in this regard. The independence of the central bank should be safeguarded by the legal basis of the central bank itself. However, this should not go as far as raising the central bank's independence to a quasi-constitutional value. While this may result in a maximum amount of legally secured independence, this can deteriorate the democratic accountability of the central bank. The reason for this is that the legal basis can, in principle, function as the ultimate instrument of democratic accountability. While the one-time democratic legitimization of the central bank, which stems from the fact that the legislator has passed the respective legislation creating the central bank functions as an *ex ante* mechanism of accountability,

this does not amount to a mechanism to hold the central bank accountable for its performance. Yet, in as much as parliament can amend the legislation it has once passed, it arguably possesses the most drastic instrument for holding the central bank accountable: it can decide to change the institutional structure of the central bank, thereby restricting its independent position and/or changing its tasks. In order to ensure that this does not result in a mitigation of the independence of the central banks per se, political systems will often include two or more veto players, making a legislative amendment a difficult exercise. Moreover, changing the legal basis of a central bank, which enjoys a high degree of credibility, may meet public resistance. Put in a nutshell, changing the legal basis may be considered the “nuclear option” in holding the central bank accountable.

Insulation of the central bank from undesirable political influence also influences the choice of the composition of the decision-making organs of the central bank and the existence of override mechanisms.<sup>46</sup> From the point of view of independence, a central bank that features government officials with voting powers on the policy board and/or features an override mechanism is likely to be much more exposed to government influence than a central bank that excludes government participation entirely.

However, the potential for disputes between the central bank and government may arguably be the highest where the central bank is given a high degree of independence in the conduct of monetary policy. Where the government is firmly in charge of monetary policy, any potential conflicts with the central bank can easily be decided to its advantage by the former. However, this may have negative effects on transparency and, moreover, could drag monetary policy into the political arena. Where monetary policy is conducted by a central bank independent from government, conflicting monetary and general fiscal policy objectives of the central bank and government, respectively, call for the existence of a conflict resolution mechanism. Adequate communication channels between the executive and the central bank can help to avoid misunderstandings and false expectations, in particular on organs of the government regarding what monetary policy can and cannot do.

Mechanisms to resolve potential conflicts are thus closely related to the independence of a central bank. On the one hand, it is the independence that gives rise to the need for a mechanism to resolve conflicts. On the other hand, it is the existence of adequate conflict resolution mechanisms in the central bank law that functions as a safeguard—or pressure valve—for central bank independence. Where such mechanisms are missing, conflict on the direction that monetary policy should take may spiral out of control, resulting in unsolicited political pressure being exercised on the central bank and/or its officials. Rather than taking place in the open and being subject to the rules laid down in the central bank law, disputes take place behind closed doors and outside public, and possibly also parliamentary, scrutiny.

While the transparent conduct of monetary policy supports both parliament and the executive in their decision-making process regarding the performance of the bank, institutionalized contacts support the overall transparency of monetary policy and any existing dialogue between monetary and fiscal policy. One way to enhance the communication between the central bank and government is to allow for the participation of government officials in central bank organs and, in particular, on the monetary policy board of the bank. To be sure, such an arrangement is difficult to maintain if the governor of the central bank is considered by law to be responsible for monetary policy and, hence, charged with taking the relevant decisions.<sup>47</sup> Representation on the monetary policy board creates a forum for government to make its views known on the general economic situation and the preferred course for monetary policy. At the same time those charged in the central bank with deciding on monetary policy can explain and motivate the approach to monetary policy.

Participation of government officials in decision-making organs of a central bank seems at odds with the model of a central bank, which is independent from government. Yet, whether or not this is actually the case depends on the concrete legal arrangements foreseen in the central bank law. In order to ensure the functional independence of the central bank, government officials should be excluded from participating in monetary policy decisions and, hence, should not have a voting right. Despite its extensive degree of independence, this arrangement can be found in existing central banks, such as at the ECB. The president of the Council of the



European Union and one member of the European Commission are entitled to participate on the Governing Council of the ECB without a voting right.<sup>48</sup> In countries in which such a passive role of government in the decision-making procedure of the monetary policy board is considered to be insufficient, an alternative may lie in providing government with the right to ask for a suspension of a monetary policy decision until the next meeting, thereby providing room also for the central bank to explain its approach. Such a possibility was foreseen in the legal basis of the Bundesbank prior to the transfer of monetary authority to the ECB and is still to be found, for example, in the Bank of Japan Law.<sup>49</sup> Arrangements whereby government officials have a voting right are to be avoided, but in any event should ensure that government representatives do not form the majority on the monetary policy board, thereby effectively controlling all decisions.

Additional or alternative arrangements providing regular contacts between the central bank and government may include a provision in the central bank law allowing for central bank officials to participate in executive government meetings when issues related to the tasks of the central bank are discussed. Such an arrangement may also give the central bank a right to be consulted when the government addresses such issues. Such a setup, which can be found in a number of central banks, may be preferred by the central banks themselves, which often fear that direct government participation in monetary policy meetings may result in undesired influencing.<sup>50</sup>

From the point of view of democratic accountability, contacts should also exist with parliament. Including both executive government and parliament in holding the central bank accountable results in what Dutzler describes as the diversification of accountability, because the various branches of government differ in their obligations to the electorate and have different motives for holding a central bank accountable.<sup>51</sup> As Majone has put it, “No one controls an agency, yet the agency is ‘under control.’”<sup>52</sup>

The role of parliament in holding the central bank accountable is a confirmation of the fact that a central bank, in principle, exercises monetary policy on behalf of the democratically elected parliament, which, at least in the national context, has delegated—but not

abrogated—these powers. Exemplary in this regard is the Fed.<sup>53</sup> Based on an obligation to submit semiannual monetary policy reports to Congress, the chairman of the Federal Reserve Board appears before the relevant standing committees of both the House of Representatives and the Senate where he is subjected to parliamentary scrutiny with regard to the performance of the Fed.<sup>54</sup> Interestingly, a similar approach is taken with regard to the ECB, where the president of the Bank appears on a quarterly basis before the relevant standing committee of the European Parliament in an exercise referred to as monetary dialogue.<sup>55</sup> Where such fora exist, parliament has the opportunity to review the performance of the central bank with regard to monetary policy on a regular basis, while the central bank is provided an opportunity to explain and justify its conduct.

As an alternative to appearances of central bank officials before parliamentary committees it is, in principle, also possible to envisage the executive government in between parliament and the central bank, such as was the case in the Netherlands prior to the enactment of the 1998 Bank Act. In such instances, the executive government rather than the central bank is answerable to the government for the conduct of monetary policy. Indeed, where the executive government is ultimately responsible for monetary policy, it takes the place of the central bank in as much as the former should be obliged to provide reasons for its conduct of monetary policy before parliament at regular intervals. However, this requires that the executive government be given instruments to hold the central bank accountable for its conduct of monetary policy, such as in the form of an override mechanism, which is further explained below. Otherwise, in practice no one institution would be accountable for monetary policy because the central bank would not be directly accountable to parliament, and the executive government could hardly be held accountable for the performance of monetary policy by a central bank over which it has no real authority.

Contact between the central bank and government should be foreseen in the legal basis of the central bank in order to form the basis for the regular and ongoing accountability of the central bank vis-à-vis parliament and/or the executive government. De facto arrangements remain the second best option given their lack of clarity and the fact that it is essentially left at the discretion of a central bank to uphold the practice.<sup>56</sup> Informal contacts entail a higher risk of being

abused, that is, to put political pressure on the central bank to pursue policies other than those determined in the legal basis and the policy target. This not only conflicts with the independent position of a central bank, but also runs contrary to keeping the bank accountable. Central bank systems that include clear rules defining the relationship between the central bank and the executive government are preferable to systems without an explicit reference to independence but also without any reference to such rules.

A clear definition of the relationship between the central bank and government arguably also must entail mechanisms that apply in the case of conflicts between an independent central bank charged with the conduct of monetary policy and the executive government charged with the conduct of fiscal policy. It is presently submitted that an override mechanism can function as such a conflict resolution mechanism. The existence of such a directive clause, as it is also sometimes referred to, can also be regarded as an important instrument of democratic accountability. This is the case not only in the sense that the central bank may be overridden in instances of suboptimal performance (thus serving as a means of sanctioning) but also in the sense that with the executive government in charge of this instrument the overall responsibility of the latter for the economic policy is recognized, even if the override mechanism is never put into practice.<sup>57</sup> With an override mechanism it is, in principle, acknowledged that policy conflicts and disagreements over monetary policy may arise between the central bank and the government. Override mechanisms can channel these conflicts.<sup>58</sup> With the existence of an override mechanism the basic premise is recognized that “... in a democratic society the government should in the limit be able to insist on its views.”<sup>59</sup> In countries where the executive government is thought to be ultimately responsible for monetary policy, the existence of an override mechanism can build the required bridge between the conduct of monetary policy by the central bank and the overall responsibility of the executive government vis-à-vis parliament.

To be sure, override mechanisms constitute the single most problematic feature in the institutional setup of a central bank because they are arguably at odds with the notion of central bank independence. However, the impact of such a mechanism on the independence of a central bank is largely determined by the concrete arrangements. First, the application of the override mechanism should

not be unconditional. Ideally, the legal basis of the central bank should lay down in detail the conditions under which an application of the override mechanism is permissible by defining the exceptional circumstances in which the central bank may be overridden.<sup>60</sup> Rather than to provide the executive government with *carte blanche* once it has taken the decision to apply the override, the legal basis should oblige the former to define and make public the alternative objectives to be observed by the central bank for the time of the application of the override, thereby committing the executive government to a certain course of action.<sup>61</sup>

Moreover, the decision to apply the override should be subject to review, thereby excluding political abuse of the mechanism. The application of the override by the executive government should be made subject to parliamentary approval or the central bank should be given the right to appeal against the application of the override mechanism, or both.<sup>62</sup> Moreover, the application of the override mechanism should be limited in time from the outset for the obvious reason that the executive government may otherwise permanently take control over monetary policy. Ideally, the legal basis will stipulate a maximum period for which the override can be applied at any one time.

As an alternative to a full-override mechanism, as has been described above, the central bank law may also give government the right to delay a decision on monetary policy from being taken. While this does not give the executive government a right to ultimately block a decision from being taken, this mechanism arguably provides for a cooling-off period in cases of disputes as well as time for further dialogue.

### **Toward a Model Central Bank Law?**

This chapter set out to establish in the short space available the basic elements forming the basis of central bank governance. This inevitably leads to the question of whether and to what extent these pillars of central bank governance and the consequences they have on the institutional structure and tasks of a central bank can form the basis for a model central bank law or, as Poole refers to, “an Optimal Central Bank Law.”<sup>63</sup> Put differently, should the emphasis lay on the drafting of a blueprint or rather the establishment of principles that

should be taken into account when designing or reforming a central bank law? Given the noticeable trend toward supranational monetary policy authorities, or at least the standardization of the rules on the basis of which national monetary policy authorities operate, this is arguably more than just an academic query.<sup>64</sup>

It could be argued that the introduction of the European System of Central Banks serves as an example of how central banks can be subjected to a particular model with regard to their institutional setup. In the case of the central banks of the member states, European Community law requires them to be independent.<sup>65</sup> As a result, all of these central bank laws have been, and, in the case of potential future member states, possibly still are, in the process of being adjusted.<sup>66</sup> However, this is not an example for the successful application of a particular central bank model to several central banks. First of all, the model concerned only a particular, albeit important, aspect of the institutional structure of a central bank, namely independence. Moreover, the reason why the central bank laws were aligned in the first place was that monetary policy authority was transferred from the level of the member states to the ECB. The fact that the central banks were deprived of their primary function anyway made it relatively easy for the member states to accept an amendment of their central bank structures in this regard.

From a purely economic point of view, it could be maintained that such a model could be established by first of all identifying those objectives that a central bank should pursue and, thereafter, by establishing the *modi operandi* along the lines highlighted above. Translated into concrete legal arrangements this would then form the ideal central bank. However, this approach is problematic given that it rests on the assumption that only one particular set of objectives and set of instruments to achieve them is plausible. However, as has been highlighted throughout this contribution with regard to the conduct of monetary policy and the relationship between the central bank and government, different institutional arrangements are feasible. In balancing independence, accountability, and transparency there is room for preferences, at least to some extent, in putting more emphasis on one or another element of governance. This is a choice that should rest with the legislative branch of government in the respective country. Indeed, in some instances the constitutional setting in which a particular central bank operates may even require

particular legal arrangements related to the governance of the central bank that are different from those necessary for another central bank.<sup>67</sup>

It will be virtually impossible to take into account the diversity of legal systems in which central banks operate in a single model central bank law. This rules out the application of a one-size-fits-all method to different central bank systems.<sup>68</sup> Central bank laws have to be observed against the background of the political, economic, and legal environment in which they are situated. This is not only the case when comparing existing central bank systems with one another, but also when considering new, or when proposing the reform of existing, central bank systems. Indeed, this need for diversity has also been recognized in some instances as attempts have been made to establish model central bank legislation.<sup>69</sup>

Preference should therefore go to the establishment of a code of good governance that could not only function as a benchmark for the assessment of central bank legislation, but also as a blueprint for the institutional structure of future central banks. As a result of the development of such practices, an international standard of central banking could emerge. Indeed, some may argue that such a standard has already emerged from practice, as a growing number of central bank systems recognize the three pillars of central bank governance in one way or another.

Already first steps have been taken toward the establishment of guidelines for good practices, whereby the IMF plays an important role in this regard. The latter conducts so-called Safeguard Assessments at borrowing central banks in order to reduce the risk of misuse of IMF resources and misreporting to the IMF. This assessment focuses on a number of areas of a central bank's governance structure,<sup>70</sup> including the legal structure and independence of the central bank. It has to be noted, however, that this assessment focuses on areas of the central bank legislation that are considered to contribute to safeguarding IMF resources and as such cannot be simply converted to an institution-building exercise.<sup>71</sup> At the same time, it may be said that these assessments provide the IMF with valuable experience in analyzing central bank legislation and include elements for the establishment of a code of good practices for central

banks, namely with regard to the conduct of monetary policy and the relationship with the executive government and parliament. The same holds true for the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies. Arguably, the implications of the proposed features already reach beyond independence and to some extent also touch upon transparency and accountability issues.

While establishing a code of good governance may over time enhance governance of central banks, this will not be a panacea. Indeed, it may be insufficient to provide for a central bank law that is based on the three pillars highlighted above in order to fully ensure that the central bank can fulfill its tasks optimally. Central bank governance has implications beyond the realm of the institutional structure of the central bank, as this requires what is presently referred to as an adequate operational environment.

While a central bank should be independent from government to a certain extent, it would at the same time be a mistake to believe that it could operate in a state of complete isolation from outside influences.<sup>72</sup> It is questionable whether a central bank can offset the effects of a government that pursues an irresponsible economic policy. Monetary policy instruments, as Asser puts it, "are designed for the conduct of monetary policy. They are not designed for other macroeconomic policies." Yet, these other macroeconomic policies, such as fiscal policy or wage policies, can affect monetary policy.<sup>73</sup>

Therefore the successful implementation of a monetary policy objective such as price stability also relies on a proper macroeconomic policy framework, of which monetary policy forms an important part. This has two implications: first, there must be a political consensus on the need for a sound macroeconomic policy and arguably on the need for a sustainable government financial position. Second, next to this there must be a legal framework in place that commits not only the central bank but also the government to the attainment of the agreed-upon macroeconomic policy objectives. The success of rules aimed at providing some form of coordination between economic and monetary policy is less than certain, as highlighted by the example of the EMU rules on economic coordination.<sup>74</sup>

An institutional setting providing for sound governance arrangements can help to achieve, but not single-handedly put in place, central bank credibility. For Issing “the life of a currency depends on the trust of the population in the stability of the money!” He continues to observe that “trust in the stability, in the credibility of politics results in lower interest rates, higher investments, and more employment.” Issing describes this as being “the contribution of monetary policy.”<sup>75</sup> Independence, accountability, and transparency cannot instantly build trust. The extent to which a central bank is embedded in society is built over time. Where existing, the credibility that a central bank enjoys can, to some extent, legitimize the policy-making of an independent central bank that is accountable only to a limited extent. The position of the Bundesbank vis-à-vis the German government and the general public in Germany prior to European economic and monetary union may serve as an example in this regard. As the keeper of the deutsche mark the Bundesbank had developed a strong reputation and a high degree of credibility not only in the financial markets but also with the general public. The Bundesbank was perceived as one of the cornerstones of German post-war economic success. This cemented its independent position vis-à-vis government and, to some extent, made the lack of mechanisms of democratic accountability acceptable.

However, the history of the Bundesbank also highlights the limits of the influence of a central bank on economic policy choices that enjoy public support. In the course of German reunification the monetary system of the German Democratic Republic (GDR) was integrated into that of the Federal Republic of Germany and the Bundesbank extended its activities to the new federal states, thereby replacing the Staatsbank, the central bank of the GDR. The Bundesbank was very skeptical about an early monetary union and opposed the one-to-one conversion rate that had been advocated by the West German federal government and thereafter was implemented in the Treaty Establishing a Monetary, Economic, and Social Union. The Bundesbank’s preference for a two-to-one conversion rate was dismissed.<sup>76</sup> At the time it was feared that the adoption of the Bundesbank’s proposal would have triggered considerable negative sentiments, and not only among the East German population. Public pressure resulted in the disregarding of the Bundesbank’s advice. This conflict between the federal government, in charge of the exchange rate policy, and the central bank, charged with the conduct of



monetary policy, had reportedly been the motive behind the subsequent resignation of the president of the Bundesbank.<sup>77</sup>

## Conclusion

This chapter set out to develop what are arguably the three pillars on which central bank governance must rest. What has emerged from this analysis are principles rather than a concrete central bank law model.

The complexity of the exercise lies in providing for all of the three elements in one and the same legal basis. In the previous sections it could be seen that, contrary to what might still be the prevailing sentiment in some quarters, this does not necessarily have to result in the (unsuccessful) attempt to square the circle. Concepts like independence, accountability, and transparency are reconcilable. Yet, certain tensions between these elements of governance cannot be ignored and have to be observed when establishing a code of good governance. A central bank that is entirely independent to not only pursue but also define monetary policy is very difficult to hold accountable for its performance. Moreover, without proper conflict resolution channels, disputes between the central bank and government may spin out of control. Furthermore, complete independence is at odds with the general notion that government, and thus elected politicians, is in principle answerable for economic policy. Indeed, as Siklos has emphasized, governments may not be sufficiently accountable if they are not responsible for setting monetary policy.<sup>78</sup> Ultimately, as Howarth and Loedel have observed: “In a democratic society, transparency and accountability are essential if central bank independence is to remain politically acceptable.”<sup>79</sup> Providing for a sufficient degree of transparency can help not only to increase the understanding of monetary policy and, as a somewhat cynical observer of events may add, the limited extent to which this is an exact science, but also to ensure that conflicts within the central bank and between the central bank and government are carried out in the open. This also functions as a restraint for government and serves to strengthen the position of the central bank independent from government and, ultimately, its credibility.

It is presently recognized that in some instances suggestions made throughout this contribution may have implications reaching beyond the structure of the central bank and the way in which it is governed. Indeed, the difficulty may rest not only in designing a central bank that is independent, accountable, and transparent all at the same time, but also in the creation of a constitutional and political environment in which such a central bank can successfully operate.<sup>80</sup> The impressive volume of documentation provided with the 1999 IMF Code of Good Practices on Transparency in Monetary and Financial Policies offers some indication as to the extent of work involved.

## Notes

<sup>1</sup> International Monetary Fund, *The IMF and Good Governance—A Factsheet* (Washington: IMF, April 2003).

<sup>2</sup> T. Lybek, “Central Bank Autonomy, Accountability, and Governance: Conceptual Framework,” in this volume of *Current Developments in Monetary and Financial Law* (Washington: IMF, 2005), pp. 133–57.

<sup>3</sup> This includes, among other issues, strategic and risk management, human resource management, and the role of ethics.

<sup>4</sup> According to Article 108 of the EC Treaty, member states are obliged to ensure that national legislation including the status of its national central bank is compatible with the EC Treaty. According to Article 109, neither the European Central Bank nor the national central banks participating in the European System of Central Banks are allowed to seek or take any instructions from Community institutions or member state institutions.

<sup>5</sup> For an overview and assessment of studies on these issues see Berger, De Haan, and Eijffinger, “Central Bank Independence: An Update on Theory and Evidence,” CESifo Working Paper Series (Cambridge and London: MIT Press, 2000), with further references. Interestingly, findings of empirical evidence still seem to vary quite considerably.

<sup>6</sup> F. Amtenbrink, *The Democratic Accountability of Central Banks—A Comparative Study of the European Central Bank* (Oxford and Portland, Oregon: Hart Publishing, 1999), at 11 *et seq.*, with further references.

<sup>7</sup> O. Issing, as quoted in G. Howarth and P. Loedel, *The European Central Bank—The New European Leviathan?* (Basingstoke: Palgrave Macmillan, 2003), at 119.

<sup>8</sup> C. Zilioli and M. Selmayr, “The European Central Bank: An Independent Specialized Organization of Community Law,” 37 *Common Market Law Review* (2000), at 591–644. *But see* R. Torrent, “Whom Is the European Central Bank the Central Bank Of? Reaction to Zilioli and Selmayr,” 37 *Common Market Law Review* (2000), at 1229–41; and F. Amtenbrink and J. De Haan, “The European Central Bank—An Independent Specialized Organization of Community Law—A Comment,” 39 *Common Market Law Review* (2002), at 65–76.

<sup>9</sup> These or similar classifications are generally in all studies. *See* S.C.W. Eijffinger and E. Schaling, “Central Bank Independence: Criteria and Indices,” Department of Economics Research Memorandum, FEW 584, University of Tilburg (1992), at 18; S.C.W. Eijffinger and J. De Haan, “The Political Economy of Central-Bank Independence,” Special Papers in Economics No. 19, International Finance Section, Department of Economics,

Princeton University, Princeton, N.J. (1996). Some of these elements are revisited in the section discussing central bank transparency.

<sup>10</sup> Amtenbrink, *supra* note 6, at 27 *et seq.*

<sup>11</sup> Amtenbrink and De Haan, *supra* note 8, at 65–66.

<sup>12</sup> This notion is discussed further in this chapter in the section on central bank transparency beginning at p. 106.

<sup>13</sup> M. Deane and R. Pringle, *The Central Banks* (London: Viking, 1993), at 320; R.M. Lastra, “The Independence of the European Central Bank,” 33 *Harvard International Law Journal* (1992), at 475–519.

<sup>14</sup> In the context of the European Central Bank, see Amtenbrink and De Haan, *supra* note 8.

<sup>15</sup> S. Maxfield, “A Brief History of Central Bank Independence in Developing Countries,” in A. Schedler, L. Diamond, and M.F. Plattner, eds., *The Self-Restraint State: Power and Accountability in New Democracies* (Boulder: Lynne Rienner Publishers, 1999), at 291, with further references, which points out that “... concern over the threat central bank independence may pose to democratic accountability could also be somewhat misplaced in a developing country context.”

<sup>16</sup> D.M. Boylan, *Defusing Democracy—Central Bank Autonomy and the Transition from Authoritarian Rule* (Ann Arbor: University of Michigan Press, 2001), at 226.

<sup>17</sup> L.W. Gormley and J. De Haan, “The Democratic Deficit of the European Central Bank,” 21 *European Law Review* (1996), at 95–112; Amtenbrink *supra* note 6, at 36–61.

<sup>18</sup> See *infra* the section dealing with good governance in the conduct of monetary policy.

<sup>19</sup> See, e.g., S.C.W. Eijffinger and P.M. Geraats, *How Transparent Are Central Banks*, CEPR Discussion Paper No. 3188 (London: 2002); J. De Haan, F. Amtenbrink, and S. Waller, “Transparency and Credibility of the European Central Bank,” 42(4) *Journal of Common Market Studies* (2004), at 775, with further references.

<sup>20</sup> A. Posen, “Six Practical Views for Central Bank Transparency,” Institute for International Economics, Working Paper (2002), at 1.

<sup>21</sup> R.M. Lastra, “How Much Accountability for Central Banks and Supervisors?” 12(2) *Central Banking* (2001), at 69–75.

<sup>22</sup> B. Winkler, “Which Kind of Transparency? On the Need for Clarity in Monetary Policy Making,” ECB Working Paper 2000, No. 26.; Eijffinger

and Geraats, *supra* note 19; De Haan, Amtenbrink, and Waller, *supra* note 19.

<sup>23</sup> Deane and Pringle, *supra* note 13, at 313.

<sup>24</sup> P. Day and R. Klein, *Accountabilities: Five Public Services* (London and New York: Tavistock Publications, 1987), at 22.

<sup>25</sup> IMF, Code of Good Practices on Transparency in Monetary and Financial Policies (1999), <http://www.imf.org/external/np/mae/mft/code/eng/code2e.pdf> [hereinafter the 1999 IMF Code].

<sup>26</sup> *Id.* at 2.

<sup>27</sup> *Id.*

<sup>28</sup> *E.g.*, D.G. Mayes, “Accountability for the Central Bank in Europe,” paper prepared for the 11th Lothian Conference (*A Central Bank for Europe*), November 19, 1997, Whitehall Place, London.

<sup>29</sup> Posen, *supra* note 20, at 168.

<sup>30</sup> *See infra* the section dealing with monetary policy formulation and communication.

<sup>31</sup> The 1999 IMF Code differentiates among the clarity of roles, responsibilities, and objectives of central banks for monetary policy; the open process for formulating and reporting monetary policy decisions; the public availability of information on monetary policy; and the accountability and assurances of integrity by the central bank.

<sup>32</sup> P.L. Siklos, “Framework for the Resolution of Government—Central Bank Conflicts: Issues and Answers,” in *Current Developments of Monetary and Financial Law*, Vol. 3 (Washington: IMF, 2005), at 375. *See also, infra* the section dealing with the central bank’s relationship with government.

<sup>33</sup> *E.g.*, V. Grilli, D. Masciandaro, and G. Tabellini, “Political and Monetary Institutions and Public Financial Institutions in the Industrial World,” 6(13) *Economic Policy* (1991), at 341–92; A. Cuckierman, S.B. Webb, and B. Neyapti, “Measuring the Independence of Central Banks and Its Effects on Policy Outcomes,” 6(3) *World Economic Review* (1992), at 353–98; A. Alesina and L.H. Summer, “Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence,” 25(2) *Journal of Money, Credit and Banking* (1993), at 151–62.

<sup>34</sup> J.O. de Beaufort Wijnholds and L.H. Hoogduin, “Central Bank Autonomy: Policy Issues,” in J.O. de Beaufort Wijnholds, S.C.W. Eijffinger, and L.H. Hoogduin, eds., *A Framework for Monetary Stability* (Dordrecht: Kluwer Academic Publishers, 1994), at 75–95.

<sup>35</sup> Art. 105(1) EC Treaty.

<sup>36</sup> F. Amtenbrink, “On the Legitimacy and Accountability of the European Central Bank: Legal Arrangements and Practical Experiences,” in A. Arnulf and D. Wincot, *Accountability and Legitimacy in the European Union* (Oxford: Oxford University Press, 2002), at 149–50.

<sup>37</sup> This is the case, for example, for the European Central Bank, since Article 105 (1) EC Treaty does not define the term “price stability” in any way.

<sup>38</sup> To be sure, this does not necessarily have to result in a nontransparent conduct of monetary policy if, and to the extent that, the bank makes its preferences public.

<sup>39</sup> In Canada, the government and the central bank agree on an Inflation Control Target (ICT). In the case of New Zealand this takes place in a Policy Target Agreement (PTA).

<sup>40</sup> C. Freedman, “Central Bank Independence,” in P. Mizen, ed., *Central Banking, Monetary Theory and Practice: Essays in Honour of Charles Goodhart*, Vol. 1 (Cheltenham: Edward Elgar Publishing, 2003), at 103.

<sup>41</sup> Adapted from Winkler, *supra* note 22. J. De Haan and F. Amtenbrink, “A Nontransparent European Central Bank? Who Is to Blame?” Working Paper, University of Groningen (2003). *See also*, J. De Haan, S.C.W. Eijffinger, and S. Waller, “The European Central Bank, Credibility, Transparency and Centralization,” CESifo Working Paper Series (Cambridge and London: MIT Press, 2005), at 83 *et seq.*

<sup>42</sup> IMF, *supra* note 25.

<sup>43</sup> The Bank of England Act 1998 provides a positive example in this respect.

<sup>44</sup> The term “government” is used as a generic term to encompass executive government and parliament.

<sup>45</sup> R. Smits, *The European Central Bank: Institutional Aspects* (London: Kluwer Law International, 1997), at 155–56; Roll Report, E. Roll, (chairman), *Independent and Accountable, A New Mandate for the Bank of England*, Report of an Independent Panel chaired by Eric Roll (London: Center for Economic Policy Research, 1993), at 21 *et seq.*

<sup>46</sup> This is referred to as organizational or political independence. *E.g.*, D. Gros and N. Thygesen, *European Monetary Integration* (London: Longman, 1992), at 420 *et seq.*

<sup>47</sup> This is the case at the Bank of England and the Reserve Bank of New Zealand.

<sup>48</sup> Art. 113, EC Treaty.

<sup>49</sup> Art. 19, Bank of Japan Law.

<sup>50</sup> The ECB has to be consulted on any proposed European Community acts falling within its field of competence and, also, on amendments of its institutional structure (Art. 105 (4) EC Treaty and Art. 48 EU Treaty). The president of the ECB has a right to participate in meetings of the Council of the European Union when the latter discusses issues relating to the tasks and objectives of the ECB. In Botswana, the Bank acts as financial adviser to the government (sec. 43 Bank of Botswana Act). In Canada, the Minister of Finance and the governor of the Bank are supposed to consult regularly on monetary policy, and on its relations to general economic policy (sec. 14(1) Bank of Canada Act). The Bank of Japan Law sets out that the Bank shall always maintain close contact with the government and exchange views sufficiently (Art. 4).

<sup>51</sup> B. Dutzler, *The European System of Central Banks: An Autonomous Actor?* (Vienna and New York: Springer, 2003), at 110.

<sup>52</sup> G. Majone, *Regulating Europe* (London: Routledge, 1996). This obligation used to be based on the Full Employment and Balanced Growth Act of 1978. The reporting was also referred to as Humphrey-Hawkins procedure, after the two sponsors of this bill. While the practice continues, the Full Employment and Balanced Growth Act of 1978 was repealed in 2000.

<sup>53</sup> As cited in Dutzler, *supra* note 51.

<sup>54</sup> For details, see Amténbrink, *supra* note 6, at 287 *et seq.*, with further references.

<sup>55</sup> For a short analysis of these hearings, see Amténbrink, *supra* note 36, at 157 *et seq.* Interestingly, European Community law does not foresee the appearance of the national central bank governors participating in the Governing Council of the ECB before the European Parliament. Depending on the legal arrangements in the different countries of origin, governors may be obliged to appear before their respective national parliament.

<sup>56</sup> Thus, for example, in the case of the ECB, not all regular contacts are prescribed by European Community law.

<sup>57</sup> Amténbrink, *supra* note 6, at 52.

<sup>58</sup> Siklos, *supra* note 32, at 5.

<sup>59</sup> Freedman, *supra* note 40, at 105.

<sup>60</sup> In the case of the Bank of England, the legal basis (sec. 19, The Bank of England Act) states that the Treasury, after consulting with the governor of

the Bank, can issue directions only if required in the public interest and by extreme economic circumstances.

<sup>61</sup> In the case of the Reserve Bank of New Zealand, the government has to announce new policy targets (sec. 12, Reserve Bank of New Zealand Act).

<sup>62</sup> In the case of the Bank of England, the Treasury order has to be laid before parliament, which thereafter has to approve the order, by a means of a resolution within 28 days. Otherwise the order ceases to have effect.

<sup>63</sup> W. Poole, “Institutions for Stable Prices: How to Design an Optimal Central Bank Law,” *Review of the Federal Reserve Bank of St. Louis* (September/October 2003), at 1–5.

<sup>64</sup> Take, for example, the case of the Banque Centrale des Etats de l’Afrique de l’Ouest and the West African Economic and Monetary Union or the model central bank legislation drafted by the Southern African Development Community (SADC).

<sup>65</sup> See *supra* the section dealing with central bank independence.

<sup>66</sup> For the impact of accession to the European Union on the structure of the national central banks, see Amtenbrink, *supra* note 6, and F. Amtenbrink, “Economic and Monetary Policy (in the Framework of the EMU),” in A. Ott and K.M. Inglis, eds., *Handbook on European Enlargement* (The Hague: T.M.C. Asser Press/Kluwer Law International, 2002), at 693–706.

<sup>67</sup> Such as is the case when, according to the constitution, government is answerable to parliament for all of economic policy including monetary policy.

<sup>68</sup> See also P.L. Siklos, “Varieties of Central Bank–Executive Relationships: International Evidence,” in this volume of *Current Developments in Monetary and Financial Law* (Washington: IMF, 2005), pp. 167–91.

<sup>69</sup> SADC Draft Model Central Bank Legislation, April 3, 2003. The explanatory note states explicitly that central banks are allowed to modify the model legislation, depending on the need for the particular country.

<sup>70</sup> IMF, “IMF Adopts Safeguards Assessments as a Permanent Policy,” Press Release No. 02/19 (April 5, 2002).

<sup>71</sup> T. Catsambas, “Safeguard Assessments and Central Bank Legislation,” in *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington: IMF, 2005), at 65.

<sup>72</sup> This has already been discussed above in the section dealing with monetary policy formulation and communication policy of the central bank.



<sup>73</sup> T.M.C. Asser, “Relative Autonomy of the Central Bank,” in *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington: IMF, 2005), at 366.

<sup>74</sup> F. Amtenbrink and J. De Haan, “Economic Governance in the European Union—Fiscal Policy Discipline versus Flexibility,” 40 *Common Market Law Review* (2004), at 1075–76.

<sup>75</sup> Author’s translation of “Eine Wahrung lebt vom Vertrauen der Bevolkerung in die Stabilitat des Geldes! Vertrauen in die Stabilitat, in die Glaubwurdigkeit der Politik wirkt sich aus in niedrigen Zinsen, hoheren Investitionen und mehr Beschaftigung. Das ist der Beitrag der Geldpolitik,” European Parliamentary Hearing during the installation of Issing, 1998.

<sup>76</sup> The Bundesbank was concerned about an excessively inflationary exchange rate.

<sup>77</sup> H. Tietmeyer, “Reflection on the German Treaty Negotiations of 1990,” in S.F. Frowen and R. Pringle, eds., *Inside the Bundesbank* (London: MacMillan, 1998), at 68–109.

<sup>78</sup> Siklos, *supra* note 32.

<sup>79</sup> Howarth and Loedel, *supra* note 7, at 123.

<sup>80</sup> In some regards, this is what the word “democratic” in democratic accountability stands for.

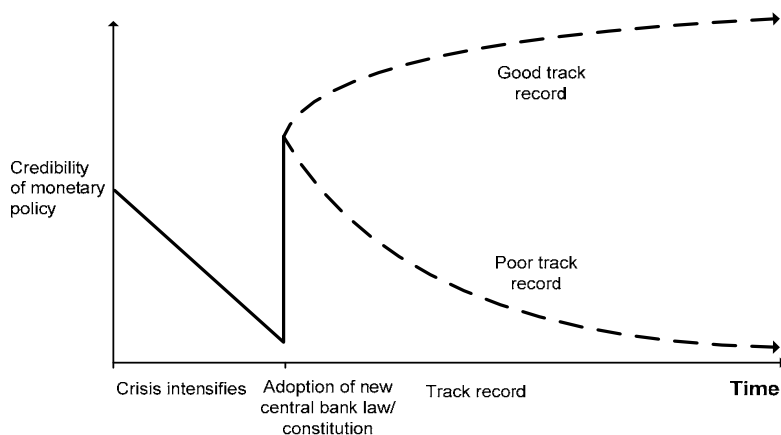
TONNY LYBEK

The International Monetary Fund (IMF) supports central bank autonomy and accountability through its facilitation of price and financial sector stability, which are conducive to sustainable economic growth. In the literature, *autonomy* is sometimes preferred to the frequently used term *independence* because autonomy entails operational freedom, while independence indicates a lack of institutional constraints. A central bank must have clearly defined and prioritized objectives, sufficient authority to achieve these objectives, and autonomy to remain credible. At the same time, it must be accountable for the authority delegated to it to ensure checks and balances. Reforming the legislative framework for a central bank—often after a crisis—can help boost the credibility of monetary policy. This reduces the perceived inflation bias and thus the real interest rate, which advances sustainable economic growth. However, a consistent reform of the legislative framework must be supported by commitment to establish a good track record, as illustrated by Figure 1.

Good central bank governance means that the objectives and tasks delegated to an institution are performed effectively and efficiently, thus avoiding misuse of resources, which is crucial for establishing a good track record. While the concept of central bank autonomy has prevailed, the last decade has focused more on accountability and transparency, but recently the focus has moved toward good governance.<sup>1</sup> Alleged infringements by directors and officers in a few countries have also advanced this trend. Good governance will only be achieved if the directors and officers are persons of great integrity, ability, and willingness to live up to their fiduciary responsibilities. For central banks, the nomination and appointment procedures, together with appropriate safeguards against undue influence, are likely to be more important for good governance

and performance than performance-enhancing incentives that may move priorities from fiduciary responsibilities to personal motives, as evidenced by recent corporate scandals. This chapter summarizes the main premises behind the policy of delegating autonomy, authority, and accountability to a central bank with clearly defined and prioritized objectives, tasks, and functions, and briefly surveys the experience.<sup>2</sup>

**Figure 1. Credibility of Monetary Policy and Reform of Central Bank Legislation**



### **The Importance of Central Bank Autonomy and Accountability**

Both price and financial sector stability are important for achieving sustainable real economic growth. Inflation—particularly variable inflation—over a certain threshold impedes sustainable economic growth. The effectiveness of the price mechanism to allocate scarce resources is impinged by the noise created by inflation. Investment and savings decisions are distorted, as people are trying to protect themselves against inflation. Moreover, inflation redistributes wealth—mainly from the poor to the wealthy owning land, real estate, or stocks. Furthermore, although governments may be tempted to use the inflation tax, high inflation also affects the budget negatively due to higher interest rates and lags in tax

collection. Although it is tempting to use inflation—which now is generally accepted to be primarily a monetary phenomenon—to “solve” short-term problems, it will hamper sustainable real economic growth by postponing addressing the underlying structural challenges.

It is the prerogative of the state to conduct monetary policy, but it may not be credible if done by the government. In the short run, the government has many competing objectives, including being reelected. Even if the government states that it will pursue price stability, the general public knows that it has incentives to compromise—the so-called time-inconsistency problem.<sup>3</sup> The public will accordingly require a risk premium in the form of higher interest rates, which impede sustainable economic growth. The delegation of authority to conduct monetary policy to an autonomous and accountable central bank with clearly defined objectives can enhance both credibility and flexibility. As long as there is short-term price stickiness, it may, according to Rogoff,<sup>4</sup> be optimal to have a “conservative central banker” weighting price stability higher than the social objective function to neutralize the myopic behavior of the government,<sup>5</sup> and the ability to better utilize new information.<sup>6</sup> In addition to price stability, financial sector stability—that is a sound and stable financial system including an efficient payment system—is also important for a market economy to realize its full potential. An autonomous and accountable central bank may help prevent undue influence from adversely affecting the financial sector.

The degree of autonomy delegated to the central bank affects the design of the structure of the governing bodies and the accountability provisions. Strong accountability provisions are needed with increased autonomy to ensure the authority delegated to the central bank is actually used as intended.<sup>7</sup> Although a new legal framework—de jure autonomy and accountability—can facilitate sustainable economic growth, the track record—the de facto autonomy and accountability—is the litmus test. Box 1 provides a summary of the recommendations for a good central bank law.

## **Box 1. Guidelines on Central Bank Autonomy and Accountability**

### **Objectives and targets**

Price stability, as the best contribution monetary policy can make to balanced sustainable growth, is the preferable formulation for the primary objective. Consistent with this broad objective, a specific target—which could, for example, involve explicit inflation targets, maintenance of a fixed exchange rate, or monetary aggregate targets—should be established and published. These targets may be determined by the central bank (target autonomy); or determined by the government in agreement with the central bank (instrument autonomy). To facilitate accountability, the target(s) should be easy to monitor. Consideration should be given to explicit, but limited, “escape clauses” in the face of significant exogenous shocks.

### **Monetary policy**

A central bank should determine and implement monetary policy to achieve its target. To this end, the central bank should have authority to determine quantities and interest rates on its own transactions without interference from the government.

### **Conflict resolution**

A clear and open process should be established to resolve any policy conflict between the central bank and the government. Some of the aspects below (e.g., the nature of government representation on the board) are potential channels for such a resolution; another approach is to allow the government to direct or overrule the central bank, but such a power should be constrained, to avoid other than exceptional use. It should be absolutely clear to the executive, legislature, and the general public that responsibility for the results lies with the government, not the central bank, if the central bank is overruled, its advice ignored, or its effectiveness is significantly limited by government policies. This may require that both the government and the central bank publish a formal statement to that extent. For instance, in cases where international reserves decline to levels insufficient to conduct international transactions due to factors outside the central bank’s control, it shall make recommendations to the government. If the government does not react within a specified period, the central bank should notify the general public that it temporarily cannot be held accountable for price stability due to factors outside its control.

### **Governor**

Nomination and appointment/confirmation of the governor should be by separate bodies to provide some measure of balance, bearing in mind the institutional framework. The term should be longer than the election cycle

of the body with the predominant role in selecting the governor. Dismissal should be only for breaches of qualification requirements, or misconduct; lack of performance could also be grounds if clearly defined in terms of the primary objective and specific targets. The latter could be ruled upon according to a suitable and independent judicial procedure, and perhaps be with the consent of the legislature.

### **Board**

Composition of the board should ensure a reasonably well-informed and balanced view, but avoid conflicts of interest. Precisely what is reasonable depends in part on the role of the board (decision-making, monitoring, or purely advisory), and whether it is a single or multiple board structure. The highest level board should include a majority of nonexecutive, nongovernment directors. Indeed, direct government representatives should be eliminated from a policy board and probably also from a monitoring board. If a government representative does participate in a policy board, it should at least be without the right to vote (though it might be with a limited, temporary veto power). As with the governor, nomination and appointment/confirmation should be by different bodies; terms should be longer than the election cycle of the main body in the appointment process and should be staggered; and dismissal of board members should occur only for breaches of qualification requirements and misconduct, and on performance grounds only if clearly defined. The latter could be ruled upon according to a suitable and independent judicial procedure, and be with the other board members' prior consent.

### **Credit to government**

If not prohibited, direct credit to the government should be carefully limited to what is consistent with monetary policy objectives and targets. For example, temporary advances and loans could be allowed only if (i) they are explicitly limited to a small ratio of average recurrent revenue of preceding fiscal years (say, 5 percent), (ii) they bear a market-related interest rate, and ideally (iii) they are securitized by negotiable securities. The central bank should not underwrite and participate as a buyer in the primary market for government securities, except with noncompetitive bids and within the overall limit for credit to government. Indirect credit to the government, that is, buying outright existing government securities held by the market, or accepting them as collateral, should be guided by monetary policy objectives. The central bank should not finance quasi-fiscal activities.

### **Exchange rate policy**

Basic consistency needs to be ensured between the exchange rate and monetary policy. If exchange rate policy (including choice of regime) is not solely the responsibility of the central bank, then the bank should nevertheless have sufficient authority to implement monetary policy within the constraint of exchange rate policy (e.g., in a fixed exchange rate

regime, to support the exchange rate as the specific target of monetary policy), and should be the principal advisor on exchange rate policy issues (e.g., as to whether the current regime is most suitable for the fundamental price stability objective). In the event of a conflict with the government on exchange rate issues, the conflict resolution procedures as stated above should come into effect.

**Financial conditions**

The law should ensure that the central bank has sufficient financial autonomy to support policy autonomy, but with matching financial accountability. Its budget should not be subject to normal annual appropriation procedures (but could be subject to a longer-term appropriation—e.g., on a cycle consistent with the term of the governor). Only realized net profits, after prudent provisioning by the central bank and appropriate allocations to general reserves, should be returned to the government. The government should ensure the solvency of the central bank by transferring interest-bearing negotiable securities if the authorized capital is depleted. The body to which the central bank is accountable should be allowed to ask external auditors and the auditor general to review the central bank's accounts and procedures.

**Publication and reporting**

Policy and financial accountability should be clearly established. The central bank should prepare formal statements on monetary policy performance at, for example, six-month intervals, without prior approval by the government. Regardless of to whom the bank is directly accountable, these statements should be forwarded to both the executive and the legislature and should be published for the benefit of the public. Annual financial statements audited by external auditors should similarly be forwarded and published. Summary balance sheets should be published more frequently (e.g., on a weekly or monthly basis).

## Different Types of Central Bank Autonomy

Distinction can be made among the following kinds of autonomy: (1) goal autonomy, (2) target autonomy, (3) instrument autonomy, and (4) limited autonomy, where the central bank basically is a government agency.<sup>8</sup>

*Goal autonomy* entrusts the central bank with responsibility for determining the monetary policy and exchange rate regime, or simply the monetary policy if the exchange rate is floating. Goal autonomy,

in principle, gives the central bank authority to determine its primary objective from among several objectives included in the central bank law or, rarely, to determine the objective if there is not one clearly defined. Thus, goal autonomy is the broadest degree of autonomy and authority. A case in point is the Federal Reserve System in the United States, which includes several potentially competing objectives in the short run.<sup>9</sup>

*Target autonomy* also entrusts the central bank or monetary authority with responsibility for determining monetary policy and the exchange rate regime, or simply monetary policy where the exchange rate is floating. In contrast to goal autonomy, target autonomy has one clearly defined primary objective stipulated in the law. The Statute of the European Central Bank (ECB) is one example in which the primary objective is to maintain price stability with the target determined by the ECB.<sup>10</sup>

*Instrument autonomy* implies that the government or the legislature decides the monetary policy or target in agreement with the central bank and the exchange rate regime, but the central bank retains sufficient authority to implement the monetary policy target using the instruments it sees fit. One example is the Reserve Bank Act of New Zealand.<sup>11</sup> There may also be a contract or an agreement between the government and the central bank that is not explicitly stipulated in the central bank law—for example, as in Canada and Norway. Usually currency board arrangements will also be considered as having some degree of instrument autonomy, unless the central bank has the authority to determine that a currency board arrangement shall be the monetary anchor.

*Limited or no autonomy* means that the central bank is almost a government agency. The government determines the policies (objectives and targets) as well as influences the implementation. The latter is primarily the case in centrally planned economies and in some developing countries.

Goal autonomy is the broadest concept, since, in principle, it gives the central bank authority to determine its primary objective among several competing objectives included in the central bank law. Target autonomy allows the central bank to decide a specific target for achieving the primary objective, which is stipulated in the law,



such as price stability. Goal and target autonomy are perceived as strong degrees of autonomy, but they also raise the question why central bankers, who are not elected by the general public, should have the authority to decide the short-term trade-off between the rate of inflation and employment. Instrument autonomy implies that the cabinet or the legislature actually decides the target, in agreement with the central bank, but the central bank retains sufficient authority to implement the target using the instruments it sees fit.

While instrument autonomy reduces the potential risk of the government manipulating monetary policy in the short run, it will not fully diminish the risk premium unless the agreement covers a long period, as the targeting horizon becomes relevant, or the target is defined by excluding seasonal and other short-run factors. It does, however, eliminate the democracy question. If the primary motivation for central bank autonomy is the fact that central bankers are better informed, rather than time-inconsistency, instrument autonomy is not sufficient to achieve an optimal solution. Provided the paradigm that price stability is the best contribution monetary policy can make to sustainable growth is acknowledged, target autonomy should be chosen, and the central bank should have, achieve, and maintain price stability as its primary objective. If this paradigm is not accepted and more emphasis instead is put on the sacrifice ratio,<sup>12</sup> but it is still accepted that specialized central bankers can best utilize the available information to avoid futile efforts to push output above its potential, it is sensible to adopt goal autonomy.

### **Clearly Defined and Prioritized Objectives, Tasks, and Functions**

The establishment of a single objective for the central bank or, at a minimum, a clearly defined primary objective, provides a more precise basis for delegating authority to the central bank and holding it accountable for its policy outcomes and its financial condition. Multiple objectives, in contrast, can hamper central bank effectiveness, dilute accountability, and complicate the coordination of economic policies with the government.

## Economic Policy (Macro) Objectives

Achieving and maintaining *domestic* price stability should be the primary objective of a central bank, since price stability is the best contribution monetary policy can make to sustainable economic growth. This follows from the analytical view that monetary policy is best suited to achieve medium-term control over inflation, while its output and employment effects are not seen as either sufficiently predictable or permanent to increase economic activity and lower unemployment. Therefore, if other macroeconomic objectives are not made subsidiary to price stability, they can weaken the credibility of monetary policy by eroding clarity and transparency. Some small open economies have decided that maintaining domestic price stability can best be achieved by pursuing a fixed exchange rate policy, which presumes that the economy and the anchor currency are affected similarly by exogenous shocks and there is a political commitment to make the necessary adjustments of the real sector.

## Financial System (Micro) Objectives

The objectives of ensuring both price stability and a sound financial system are mutually consistent, at least in the longer run. While inadequate monetary policies could lead to inflation and contribute to a shaky financial system, an unsound financial system could lead to a systemic financial crisis and impinge on monetary policy and, thereafter, on price stability. Therefore, in general, recent central bank laws prescribe the soundness of the financial system as an objective that is subordinated to medium-term price stability. To avoid possible conflicts of interest, it is important that the laws specify the central bank's role regarding:

- **Lender of last resort:** The central bank should only support illiquid—but solvent—banks that are of systemic importance. It should only be authorized to do so against clearly defined collateral, which could include government guarantees;
- **Payment systems:** The design of the payment systems is crucial for reducing systemic risk and, thus, the likelihood of the central bank having to function as a lender of last resort. Accordingly the central bank should have the authority to oversee key aspects of the payment system; and

- **Banking supervision:** There is a potential conflict between conducting monetary policy and banking supervision. A central bank could be tempted to relax monetary policy to address financial sector problems that might have arisen because of weaknesses in its supervision instead of addressing the underlying structural problems. This, combined with the growing integration of financial service providers, is viewed by some as a good reason to separate the responsibility for prudential supervision from the central bank and to entrust it to an autonomous specialized agency. On the other hand, a government agency in charge of banking supervision may be more prone to political pressures to license weak banks and not to enforce prudential regulation—particularly for state-owned banks. This may undermine monetary policy more than an autonomous central bank in charge of banking supervision. In some countries, the central bank may be the only institution with adequate resources and sufficient strength to withstand potential government interference on supervisory matters. It is just as crucial that the same guiding principles ensuring consistency between objectives, authority, autonomy, and accountability for monetary policy also be used for the delegation of authority to supervise the financial sector.<sup>13</sup>

## Authority

### Monetary Policy

A central bank should have sufficient authority to formulate and implement monetary policy within the constraints stipulated by its objectives and the autonomy delegated to it. A central bank should be able to control its balance sheet to influence liquidity conditions in the banking system, and thus ultimately influence price stability. The specific allocation of credit should be left to the commercial banks, or the government and the legislature to the extent they want to influence credit allocation via tax and investment incentives. If the financial markets are underdeveloped, the central bank may need to rely on direct monetary instruments; it then becomes even more important to fully isolate the central bank from undue external influence, since such measures usually affect credit allocation.

### ***Credit to the Government***

Restrictions on the central bank's direct monetary financing of the government make it possible to separate monetary and fiscal policy, leaving more authority to the central bank. While a target for monetary policy implicitly sets limits for monetary financing of the budget, it is the experience, particularly in developing countries, that without explicit limits for credit to the government, the central bank will face difficulties in achieving price stability.

Direct credit to the government should ideally be prohibited, but in countries without a well-developed market for government securities or in countries where there are strong seasonality and major timing mismatches in the flow of the government's revenues and expenditures, temporary advances could be permitted, provided that they are of a short-term nature and do not exceed an explicit limit.<sup>14</sup> Prohibiting lending to the government protects the central bank from government pressure. The central bank may lend to the government indirectly by buying government securities in the secondary markets through open market operations or by accepting them as collateral for loans to commercial banks. These operations should not be prevented, where conducted at the initiative of the central bank in the pursuit of monetary policy objectives. The potential for quasi-fiscal activities should be eliminated in the central bank law, which can be done by explicitly prohibiting activities that are not provided for under the act and that are not consistent with the appropriately defined objective(s) of the central bank.

### **Exchange Rate Policy**

In light of increased capital mobility, newer central bank laws often delegate the authority over the exchange rate regime to the central bank in consultation with the government. Monetary and exchange rate policies are inextricably linked, particularly in countries with a convertible currency and free capital mobility. It can thus be argued that an autonomous central bank also must be in charge of deciding the exchange rate policy, if it is responsible for controlling inflation.<sup>15</sup> However, this is based on the assumption that the exchange rate movements simply reflect changes in money demands and supplies, while in practice, particularly in the short run, numerous factors under the authority of the government affect the real

exchange rate. Careful consideration must thus be given to country-specific conditions.

## **Political Autonomy**

### **Governance Structure**

The central bank law should define a governance structure that will limit the risk of undue interference and government pressure in the exercise of its powers. Depending on the degree of autonomy delegated to the central bank, there are up to five distinct functions of governing bodies. They are (i) making policy decisions (determining the target in case of goal and target autonomy); (ii) advising the decision makers of the central bank (in case there are concerns that the autonomy delegated to the central banks may not fully ensure a balanced view); (iii) making decisions on how to execute the policy; (iv) implementing the decisions (management or, sometimes, a management board or just the governor); and (v) monitoring the (a) policy performance, (b) financial condition of the central bank, and (c) use of bank resources. Some countries only have one board performing several of these functions with the governor responsible for the day-to-day operations, while other countries may have several boards, such as a policy board, a supervisory board, an audit committee, and the governor, or a general manager, acts as chief executive officer. Needless to say the composition of the board(s) should reflect its function(s), while at the same time try to depoliticize the decision-making process and take into account country-specific conditions, including corporate law.

To ensure political autonomy, the following elements, among others, should be considered:

- The governor, deputy governors, and board members should observe certain qualification requirements, including being of good moral standing and having relevant experience. Government officials, if considered necessary, should constitute a minority, be included only to ensure information sharing, and, ideally, not have the right to vote. Boards with oversight responsibilities should have external members, ideally the majority, to avoid the management of the central bank from overseeing itself.

- The nomination and appointment of the governor, and ideally also of members of the board(s), should, if at all possible, be done by separate arms of the government to provide some measure of balance.
- The term of a board member should be longer than the election cycle of the body with the predominant role in selecting the member. Terms should be staggered to ensure continuity and facilitate accountability.
- Government directives to the central bank or the members of its decision-making bodies should ideally be explicitly prohibited—unless considered necessary as a safety valve to be used only in extraordinary cases—since they should be solely responsible for exercising the powers and carrying out the tasks conferred upon them by the law.
- Remuneration should not be changed to the members' disadvantage during their term of office to avoid it being used to unduly influence the policies of the central bank.
- The governor should be dismissed only for breaches of qualification requirements or gross misconduct. Depending on country-specific conditions, the (supervisory) board, an independent tribunal, or the supreme court could rule upon the latter, ideally with the consent of the legislature. Other board members should also be protected from arbitrary dismissal. Often these requirements are less rigorous, but they should ideally be the same as for the governor.

The legal framework should provide for functional immunity of members of the governing bodies and central bank staff for actions taken in good faith while discharging their duties. This is particularly important for central bank staff performing banking supervision or involved in payment systems.

## **Coordination and Conflict Resolution Procedures**

Although a central bank is autonomous, there is still a need to ensure close coordination with the government in a number of areas. This can be facilitated by clearly defined and prioritized objectives stipulating that without prejudice to the primary objective and financial sector stability, the central bank shall support the general economic policies of the government. At the same time the legislative framework should define procedures to resolve potential conflicts with the government. The government's right to overrule the central bank during exceptional circumstances may be viewed as a safety valve, as long it is done in a transparent way. However, if frequently used, it would undermine the purpose of establishing an autonomous central bank and re-create the inflation bias. Newer central bank laws therefore often exclude such a safety valve and instead clearly stipulate that the central bank be an autonomous legal entity. If, for instance, the government is responsible for the exchange rate regime, the exchange rate is pegged, and international reserves decline below a threshold considered by the central bank to be necessary to ensure a smooth flow of international transactions, the central bank should be obligated to make recommendations to the government. If the government does not react within a specified period, the government should publicly justify its policy choice. The central bank should be transparent and ideally explain that temporarily it can no longer be responsible for price stability due to factors outside its control.

## **Financial Autonomy**

The central bank's financial integrity should be protected to prevent it becoming subject to indirect influence from the government via appropriation procedures or as the result of significant losses depleting its capital. Profitability should not in itself be a central bank objective, as it could adversely affect achieving and maintaining price stability.

A central bank should have an initial authorized capital and accumulate general reserves until the equity capital is sufficient to cover its risks. In practice, however, how to determine the appropriate level of equity capital of a central bank is widely discussed.<sup>16</sup> Typically, the initial authorized capital is established and a share of profits is continuously allocated to general reserves until they reach a

multiple of the authorized capital or a ratio of, for example, monetary liabilities that function as a proxy for the risks the equity capital is supposed to cover.

It is important that the central bank first make prudent provisions and allocations to general reserves, and only afterwards transfer *realized profits* net of unrealized losses to the owner(s) of the central bank, usually the government. It is advisable that the central bank make prudent provisions according to sound accounting standards, thus avoiding the need for establishing special reserve funds. To ensure that losses do not deplete the initial capital and make the central bank economically dependent on the government, the central bank law should include provisions that obligate the government to recapitalize the central bank. A continuous depletion of the central bank's capital amounts to providing direct credit to the government and is often the result of policies the government forces on the central bank. Accordingly, the government should be obligated to automatically recapitalize the central bank. Finally, central banks should not be subject to frequent appropriation procedures, but it may prove useful if they are obligated to submit an estimate of expenditures for information purposes with a view to ensuring financial accountability.

### **Accountability**

When the state delegates authority to a central bank and gives it autonomy, the central bank must be made accountable to ensure appropriate checks and balances and to minimize any abuse of powers by any of the parties involved. The accountability provisions should thus ensure that an autonomous central bank uses its delegated authority effectively and efficiently to achieve its primary objective, namely price stability, as well as its other tasks, and manages its resources in a prudent manner.

An autonomous central bank is ultimately accountable to the general public, but may be directly accountable to the executive branch or the legislature. Often it depends on tradition and the governance structure. For example, a separate supervisory board may exist but it should be clear to which arm of government—often the



legislature in newer central bank laws—the central bank is formally accountable to avoid dilution of responsibilities.

### **Monetary Policy and Other Tasks**

To facilitate performance monitoring, the central bank law should stipulate that the central bank publish policy statements at a minimum once a year, as well as an annual report on its monetary policy performance and its other operations. An increasing number of laws now require the central bank to present semiannual monetary policy statements, and central banks usually publish more frequent reports and analyses on monetary policy. Frequent information on monetary policy can also make it more difficult for the government to intervene without the general public being informed. The reporting should clearly define factors within or outside the central bank's control that affected the outcome.<sup>17</sup>

### **Financial Conditions**

Sound business practices are important for the credibility of the central bank and support its financial autonomy. Should sound practices not be implemented, the government may feel a need to further control the central bank. It is therefore highly desirable that the central bank, as a minimum, publish *audited* annual financial statements—ideally audited by independent external auditors. The use of international financial reporting standards is increasingly being recommended, but this necessitates that the central bank law clearly stipulates that only *realized* profits can be transferred to the government. Summary balance sheet information should be published more frequently—at a minimum monthly. In addition to audited annual financial statements, the supervisory board or the body to which the central bank is formally accountable should have the right to ask for an external audit of the adequacy of any central bank procedure.

## Empirical Evidence

Empirical studies of central bank autonomy and accountability are supportive<sup>18</sup> but not compelling. There are basically three types of studies, and most of them focus on autonomy rather than accountability. Many studies simply compare an index of the central bank's *de jure* autonomy and accountability with inflation performance. The design of the index—that is, the elements considered, their weights, and normalization procedures—affects the results.<sup>19</sup> Another type of study also tries to find a correlation, but takes other factors into account. For instance, such studies estimate whether the correlation between autonomy and inflation performance is stronger or weaker depending on the exchange rate policy, openness of the economy, monetization of budget deficits, debt ratios, and so forth. Finally, there are a few event studies that try to estimate if inflation performance or the level of interest rates have changed before and after significant amendments of the legislative framework.

Several studies have shown that during the period following the breakdown of the Bretton Woods system of fixed par values in the early 1970s, the industrialized countries that accorded greater legal autonomy to their central banks also experienced lower average inflation.<sup>20</sup> Evidence from these countries further strengthened the case for central bank autonomy because the higher degree of autonomy did not appear to harm average real growth,<sup>21</sup> although a discussion of sacrifice ratios has later emerged.<sup>22</sup> However, in the last decade with lower inflation, since there has been a general political commitment to combat inflation, it has become increasingly difficult to identify a correlation between more autonomy and accountability and lower inflation. Daunfeldt and de Luna, for instance, find that the decline in inflation often has happened before reforms of the legislative framework.<sup>23</sup> A few event studies have been produced, like the one showing that the announcement of the new legislative framework for the Bank of England in 1997 did coincide with a decline in the interest rate.<sup>24</sup>

The correlation between legal autonomy and lower inflation does not appear to be empirically significant in developing countries.<sup>25</sup> Schuler, for instance, finds, based on a survey of 156 countries analyzing the period 1952 to 1993, that developing countries with

central banks have performed worse than other monetary systems and central banking in developed countries.<sup>26</sup> The lack of strong empirical evidence of central bank autonomy in developing countries may be due to the use of other monetary anchors. Anyadike-Danes, for example, finds that the linkage between central bank autonomy and inflation performance is much weaker in developing countries with a pegged exchange rate than in other developing countries.<sup>27</sup> It has also been argued that de jure autonomy and accountability may be a poor proxy for de facto autonomy. Fry, for example, finds that in developing countries, the size of the budget deficit and its financing dominate the standard measures for central bank independence.<sup>28</sup> Furthermore, there may simply be different preferences between inflation, employment, and development in developing countries. Finally, the decision makers may in some developing countries be less sensitive to the political election cycle. Jácome and Vázquez, however, do find correlation between stronger autonomy and better inflation performance in Latin America and the Caribbean, when taking into account fiscal stance and exchange rate regime.<sup>29</sup>

Several studies have found correlation between stronger central bank autonomy and better inflation performance in selected transition economies.<sup>30</sup> Furthermore, it appears that transition economies delegating more autonomy and accountability to their central bank also generally have been most successful in upgrading the monetary and financial framework to the needs of a market economy.<sup>31</sup>

Even when supporting empirical evidence is found, the causality question remains: is it central bank autonomy and accountability that cause good inflation performance, or is it the commitment to pursue sound economic policies that causes good inflation performance and central bank autonomy and accountability? Some studies have used proxies for de facto central bank autonomy, like the turnover rate of the governor.<sup>32</sup> De Haan and Kooi, using a sample of 82 developing countries, do find that higher turnover of governors is positively related to inflation only if high inflation countries are included in the sample.<sup>33</sup> A governor, however, may remain in office either because he or she implements sound policies or because of willingness to accommodate government instructions.

## **Entrenchment of Central Bank Autonomy and Accountability in the Constitution**

If the need for central bank autonomy and accountability is accepted, there are valid reasons to entrench these concepts in the constitution. Older constitutions are typically fairly silent regarding the central bank. Constitutions of transition economies are often quite detailed regarding nomination, appointment, and in some cases dismissal of the governor and other board members. Only a few constitutions, like the one in South Africa, explicitly specify the objective of the central bank. Several Latin American countries, after the problems in the early 1980s, have amended their constitutions and included fairly detailed provisions on the central bank, including prohibiting direct central bank credit to the government. Gutiérrez, for instance, applied an index covering both autonomy and accountability on the constitutions of Latin American countries.<sup>34</sup> She takes into account several factors and does find a significant relationship between a higher degree of autonomy and accountability in the constitution and better inflation performance.

### **Conclusion**

An appropriately designed central bank law, perhaps with key provisions entrenched in the constitution, can contribute to the credibility of monetary policy. It is crucial to acknowledge that central bank autonomy and accountability facilitate price and financial sector stability, which are conducive to sustainable economic growth. A good legislative framework makes monetary policy more credible, while at the same time allowing more flexibility. A central bank law should have clearly defined and prioritized objectives, and it should delegate sufficient authority and autonomy to the central bank to achieve these objectives, while at the same time ensure checks and balances. There must be consistency among the objectives of the central bank, its authority, degree of autonomy, and accountability. Inconsistencies may not just endanger the credibility of the monetary authority but jeopardize confidence in the overall legal framework. In reaction to a crisis, it may be tempting to focus on addressing the problems perceived as having caused the crisis and simply “copy” a law from a country with a good track record, while not fully acknowledging that other conditions may be

quite different. To be successful, however, it is important to adapt the law to local conditions. A strengthened legislative framework will only be successful if combined with a good track record.

## Notes

<sup>1</sup> See, e.g., Henry Schiffman, “Good Governance for Central Banks,” *Central Banking* (London: Central Banking Publications Ltd., 2004), at 42–46.

<sup>2</sup> For a more detailed discussion of central bank autonomy, see for instance, Tonny Lybek and JoAnne Morris, “Central Bank Governance: A Survey of Boards and Management,” IMF Working Paper 04/226 (Washington: IMF, 2004); Alex Cukierman, “Does a Higher Sacrifice Ratio Mean that Central Bank Independence Is Excessive?” *Annals of Economics and Finance*, Vol. 3, at 1–25, and “Central Bank Independence and Monetary Control,” 104(427) *Economic Journal* (November 1994), at 1437–38; Helge Berger, Jacob de Haan, Sylvester C.W. Eijffinger, “Central Bank Independence: An Update of Theory and Evidence,” Discussion Paper Series No. 2353 (Center for Economic Policy Research, 2000); Tonny Lybek, “Elements of Central Bank: Autonomy and Accountability,” Monetary and Exchange Affairs Department Operational Paper 98/1 (Washington: IMF, 1998); Stanley Fischer, “Central Bank Independence Revisited,” *American Economic Review, Papers and Proceedings* (May 1995), at 643–64, and “Modern Approaches to Central Banking,” National Bureau of Economic Research Working Paper No. 5064 (Cambridge, Mass.: National Bureau of Economic Research, 1995).

<sup>3</sup> F.E. Kydland, and E.C. Prescott, “Rules Rather Than Discretion: The Inconsistency of Optimal Plans,” 85(3) *Journal of Political Economy* (June 1977), at 473–92.

<sup>4</sup> Kenneth Rogoff, “The Optimal Degree of Commitment to an Intermediate Monetary Target,” 100(4) *Quarterly Journal of Economics* (November 1985), at 1169–90.

<sup>5</sup> Alan S. Blinder, “Central Banking in Theory and Practice” (Cambridge, Mass.: MIT Press, 1998).

<sup>6</sup> Christina D. Romer and David H. Romer, “Institutions for Monetary Stability,” Chapter 8 in *Reducing Inflation: Motivation and Strategy*, National Bureau of Economic Research (Chicago: University of Chicago Press, 1997), at 307–29.

<sup>7</sup> Stanley Fischer, “Central Bank Independence Revisited,” *American Economic Review, Papers and Proceedings* (May 1995), at 201–206; and Manuel Guitián, “Central Bank Independence: Issues and Diversity of Models,” a paper prepared for a workshop on Independence and Accountability: The Role and Structure of the South African Reserve Bank

(January 1995), and “Aspects of Central Bank Independence and Monetary Policy,” a Special Lecture, Reserve Bank of India (November 1995).

<sup>8</sup> Certain literature distinguishes only between goal/target autonomy and instrument autonomy: Guy Debelle and Stanley Fischer, “How Independent Should a Central Bank Be?” in *Goals, Guidelines, and Constraints Facing Monetary Policy*, Conference Series No. 38, Jeffrey C. Fuhrer, ed. (Boston: Federal Reserve Bank of Boston, 1994), at 195–221. Other literature distinguishes between goal and target autonomy: Tonny Lybek, “Central Bank Autonomy, and Inflation and Output Performance in the Baltic States, Russia, and Other Countries of the Former Soviet Union, 1995–97,” IMF Working Paper 99/4 (Washington: IMF, 1999), also published in 35(6) *Russia and East European Finance and Trade* (1999), at 7–44; and Tonny Lybek, “Elements of Central Bank: Autonomy and Accountability,” Monetary and Exchange Affairs Department Operational Paper 98/1 (Washington: IMF, 1998). The European Monetary Institute, the predecessor to the European Central Bank (ECB), used the following categories to assess whether the respective central banks were sufficiently autonomous: institutional independence, functional independence, organizational independence, and financial independence as discussed, for example, by Fabien Amtenbrink, *The Democratic Accountability of Central Banks* (Portland, Ore., and Oxford: Hart Publishing, 1999). These terms all cover important aspects of autonomy but they are not different types of autonomy; rather, they are different elements of autonomy.

<sup>9</sup> According to Sec. 2A of the Federal Reserve Act: “The Board of Governors of the Federal Reserve System and the Federal Open Market Committee (FOMC) shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy’s long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

<sup>10</sup> Article 2 of the Protocol of the Statute of the European System of Central Banks (ESCB) and the European Central Bank: “In accordance with Article 105(1) of this Treaty, the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it 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 of this Treaty. 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 of this Treaty.”

<sup>11</sup> Article 8 of the Reserve Bank Act of New Zealand stipulates: “The primary function of the Bank is to formulate and implement monetary policy

directed to the economic objective of achieving and maintaining stability in the general level of prices.” Article 9(1) stipulates: “The Minister shall, before appointing, or reappointing, any person as Governor, fix, in agreement with that person, policy targets for the carrying out by the Bank of its primary function during that person’s term of office, or next term of office, as Governor.”

<sup>12</sup> The sacrifice ratio is the cumulative output loss arising from a permanent reduction in inflation.

<sup>13</sup> See, e.g., Eva Hüpkes, Marc Quintyn, and Michael W. Taylor, “The Accountability of Financial Sector Supervisors,” IMF Working Paper (Washington: IMF, forthcoming); Marc Quintyn and Michael W. Taylor, “Regulatory and Supervisory Independence and Financial Stability,” 49(2) *CESifo Economic Studies* 259, (2003), <http://www.cesifo-economic-studies.de>; and Richard K. Abrams and Michael W. Taylor, “Issues in the Unification of Financial Sector Supervision,” IMF Working Paper 00/213 (Washington: IMF, 2000).

<sup>14</sup> Carlo Cottarelli, *Limiting Central Bank Credit to the Government, Theory and Practice*, Occasional Paper No. 110 (Washington: IMF, 1993). As an aside, a few central banks have special provisions regarding *intraday* liquidity with a view to lubricate the real-time gross settlement system.

<sup>15</sup> Carlo Cottarelli, “Should an ‘Independent’ Central Bank Control Foreign Exchange Policy?” Chapter 12 in *Frameworks for Monetary Stability*, Tomas J.T. Baliño and Carlo Cottarelli, eds. (Washington: IMF, 1994).

<sup>16</sup> Kenneth Roy Sullivan, “Profits, Dividends and Capital—Considerations for Central Banks,” in *Accounting Standards for Central Banks*, Neil Courtis and Benedict Mander, eds. (London: Central Banking Publications, Ltd., 2003).

<sup>17</sup> The IMF’s Code of Good Practices on Transparency in Monetary and Financial Policies (Washington: IMF, 1999), <http://www.imf.org/external/np/mae/mft/index.htm>, provides some guidance.

<sup>18</sup> See, e.g., Berger et al., “Central Bank Independence: An Update of Theory and Evidence,” Discussion Paper Series No. 2353 (Center for Economic Policy Research, 2002).

<sup>19</sup> Gabriel Mangano, “Measuring Central Bank Independence: A Tale of Subjectivity and of Its Consequences,” 50(3) *Oxford Economic Papers* (July 1998), at 468–92.

<sup>20</sup> See, e.g., Vittorio Grilli, Donato Masciandaro, and Guido Tabellini, “Political and Monetary Institutions and Public Financial Policies in



Industrial Countries,” in 6(13) *Economic Policy: A European Forum*, (1991), at 342–91.

<sup>21</sup> Alberto Alesina and Lawrence H. Summers, “Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence,” *Journal of Money, Credit and Banking* (May 1993), at 151–62.

<sup>22</sup> Alex Cukierman, “Does a Higher Sacrifice Ratio Mean That Central Bank Independence Is Excessive?” *Annals of Economics and Finance*, Vol. 3 (2002), at 1–25.

<sup>23</sup> Sven-Olov Daunfeldt and Xavier de Luna, *Central Bank Independence and Price Stability: Evidence from 23 OECD Countries*, Swedish Research Institute of Trade, Department of Statistics, Umeå University (2003).

<sup>24</sup> Mark M. Spiegel, “Central Bank Independence and Inflation Expectations: Evidence from British Index-Linked Gilts,” 1998(1) *Economic Review* of the Federal Reserve Bank of San Francisco 3–14.

<sup>25</sup> See Cukierman, *supra* note 3, at 1437–48.

<sup>26</sup> Kurt Schuler, *Should Developing Countries Have Central Banks?* Institute of Economic Affairs (Baltimore: Johns Hopkins University, 1996).

<sup>27</sup> M.K. Anyadike-Danes, “Comments on Measuring the Independence of Central Banks and Its Effect on Policy Outcomes by Cukierman, Webb, and Neyapati,” 9(2) *World Bank Economic Review* (1995), at 335–40.

<sup>28</sup> Maxwell J. Fry, “Assessing Central Bank Independence in Developing Countries: Do Actions Speak Louder Than Words?” *Oxford Economic Papers* (July 1998), at 512–29.

<sup>29</sup> Luis I.H. Jácome and Francisco Vázquez, “Any Link Between Legal Central Bank Independence and Inflation? Evidence from Latin America and the Caribbean,” IMF Working Paper 05/75 (Washington: IMF, 2005).

<sup>30</sup> See, e.g., Cukierman et al., “Central Bank Reform, Liberalization, and Inflation in Transition Economies—An International Perspective,” CEPR Discussion Paper No. 2808 (London: Center for Economic Policy Research, 2001); and Woljciech S. Maliszewski, “Central Bank Independence in Transition Economies,” 8(3) *Economics of Transition* (2000), at 749–89; Prakash Loungani and Nathan Sheets, “Central Bank Independence, Inflation, and Growth in Transition Economies,” 29(3) *Journal of Money, Credit and Banking* (August 1997), at 38–99; and Tonny Lybek and JoAnne Morris, “Central Bank Governance: A Survey of Boards and Management,” IMF Working Paper 04/226 (Washington: IMF, 2004).

<sup>31</sup> Tonny Lybek, “Central Bank Autonomy, and Inflation and Output Performance in the Baltic States, Russia, and Other Countries of the Former Soviet Union, 1995–97,” IMF Working Paper 99/4 (Washington: IMF, 1999), also published in 35(6) *Russian and East European Finance and Trade* (1999), at 7–44.

<sup>32</sup> Steven B. Webb and Bilib Neyapti, “Measuring the Independence of Central Banks and Its Effect on Policy Outcomes,” 6(3) *World Bank Economic Review* (1992), at 352–98.

<sup>33</sup> Jacob de Haan and Willem J. Kooi, “Does Central Bank Independence Really Matter? New Evidence for Developing Countries Using a New Indicator,” 20 *Journal of Banking and Finance* (2000), at 643–64.

<sup>34</sup> Eva Gutiérrez, “Inflation Performance and Constitutional Central Bank Independence: Evidence from Latin America and the Caribbean,” IMF Working Paper 03/53 (Washington: IMF, 2003).

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**Interaction of Monetary and Fiscal Policies: Why Central Bankers Worry About Government Budgets**

PAUL HILBERS

This is a topic on which there is an abundance of literature. Books are filled with information on the topic of the interaction between monetary and fiscal policies, which is one of the key, but also one of the more complex, relationships in economic theory. With the role of the central bank lawyer in mind, the discussion below will address the issue from one specific angle, namely the relevance of fiscal policy for central bankers.

Fiscal policy generally refers to the government's choice regarding the use of taxation and government spending to regulate the aggregate level of economic activity. In the same vein, the use of fiscal policy entails changes in the level or composition of government spending or taxation, and hence in the government's financial position. Key variables that policymakers focus on include government deficits and debt, as well as tax and expenditure levels.

Monetary policy refers to the central bank's control of the availability of credit in the economy to achieve the broad objectives of economic policy. Control can be exerted through the monetary system by operating on such aggregates as the money supply, the level and structure of interest rates, and other conditions affecting credit in the economy. The most important objective of central bankers is price stability, but there can be others, such as promoting economic development and growth, exchange rate stability and safeguarding the balance of external payments, and maintaining financial stability. Key variables in this policy area include interest rates, money and credit supply, and the exchange rate.

While monetary and fiscal policy are implemented by two different bodies, these policies are far from independent. A change in one will influence the effectiveness of the other and thereby the overall

impact of any policy change. Tensions can arise between what each will do to help smooth economic cycles and achieve macroeconomic stability and growth. That is why it is crucial to pursue a consistent monetary-fiscal policy mix and coordinate these (and other) policies as much as possible to avoid tensions or inconsistencies. This policy mix is a key component of the International Monetary Fund's (IMF's) macroeconomic policy advice and of IMF-supported economic adjustment programs, together with external, structural, and financial sector policies. In practice, imbalances in the budgetary position have in many cases proven to be a key element in both macroeconomic problems and their solution. For this reason, the IMF was sometimes jokingly said to stand for "It's Mostly Fiscal," although in reality the macroeconomic problems countries are faced with generally consist of a broader mix of imbalances and require a broader set of policy responses.

### **Relationship**

How does fiscal policy affect monetary policy and thus the central banks? There are both direct and indirect channels. Starting with the first category, there are a number of ways in which fiscal policy may impinge on monetary policy. First and foremost, an expansionary fiscal policy may result in excessive fiscal deficits, which may create a strong temptation for governments to resort to the printing press (i.e., monetary financing by the central bank) to finance the deficits. An expansionary fiscal policy, then, leads to an expansionary monetary policy, fueling inflationary pressures, causing a possible real appreciation of the currency and hence balance of payments difficulties, potentially even resulting in a currency (and/or banking) crisis.

But even if governments finance their deficits in a nonmonetary way, that is, through the markets, there may be cause for concern, specifically about crowding out: if governments take up too much funding in the markets, the result may be too little or too expensive credit for the private sector. This may harm economic development and growth, which would certainly be a concern of central bankers. On the external side, there is the risk that too much dependence on foreign funding of domestic debt results in exchange rate and/or balance-of-payments risks, which again would be worrying to central banks.

There is another, more direct channel of fiscal policy affecting central bankers and that is the impact of indirect taxes on the price level and thus on inflation. If governments feel forced to resort to substantial increases in indirect taxes—sales taxes, value added taxes—rather than taxes on various forms of income, this will have a direct impact on prices. The key concern here is that a one-off increase leads to a wage-price spiral and therefore permanent (higher) inflation and inflationary expectations.

In addition to these direct relationships between fiscal and monetary policy, there is the more indirect channel through expectations. Perceptions and expectations of large and ongoing budget deficits and resulting large borrowing requirements may trigger a lack of confidence in the economic prospects. This may become a risk to the stability in financial markets. Such a lack of confidence in the sustainability of the financial position of the government may become a potential destabilizing factor on bond and foreign exchange markets, eventually even leading to the collapse of the monetary regime.

### **Impact of Fiscal Expansion**

Conceivably, expansionary fiscal policy may at some stage become ineffective as a means to stimulate demand and, similarly, fiscal contractions may turn out to be expansionary.<sup>1</sup> When economic agents realize that the government is borrowing too much for its own good, they will conclude that this can only lead to higher taxation levels in the future, and they may decide to compensate for that now by saving more and consuming less. This so-called “Ricardian equivalence” means that the financial behavior of economic agents—on which central banks base their monetary policy decisions—depends on their perception of fiscal sustainability. It is therefore another example of how fiscal policy can (indirectly) affect the effectiveness of monetary policy.

It should be noted that the impact of fiscal policy on central bank objectives is not automatically avoided when the central bank is independent. Even when the central bank has independence, and hence is not submitted to the fiscal needs of the government, the need to offset the impact of expansionary fiscal policy on aggregate demand and inflation in the economy could prompt the central bank to tighten monetary policy, by raising interest rates or reducing credit

in the financial system. The resulting high interest rates could depress economic activity and attract short-term and easily reversible capital inflows—thereby adding to inflation and appreciation pressures on the currency, and eventually damaging macroeconomic and financial stability.

Severe budgetary problems may even lead to crises. There have been a number of examples of such severe tensions in the past, in which large and growing fiscal deficits—in the absence of needed public sector reforms—led to high real interest rates. This intensified the government's debt-servicing costs, causing a buildup of short-term and foreign currency-linked public debt, thus increasing the sensitivity to interest rate, exchange rate, and rollover risks, which materialized as foreign capital inflows that had helped to finance the debt were suddenly reversed. Examples of this set of circumstances were apparent in the run-up to the crises in Turkey (1994, 2001), Mexico (1994), Russia (1998), Brazil (1999), and Argentina (2001).

Even in countries where such extreme conditions did not materialize, the sustainability of the monetary regimes can be challenged by fiscal policies that are too accommodating. This has happened in the past in, for example, Israel and Poland where expansionary fiscal policy caused an overheating of the economy, reviving inflationary pressures and worsening the current account. High interest rates—required to contain inflation—attracted capital inflows that complicated the implementation of monetary policy. Sterilization of capital inflows to keep inflation in check became increasingly difficult and costly for the central bank.

### **Financial Markets**

Another area where monetary and fiscal policy come together is the development of financial markets. Both finance ministries and central banks have a strong interest in financial market development because (1) it is indispensable for economic development and growth, (2) it facilitates funding of deficits and debt, and (3) it enables market-based operations by central banks. As part of financial market development, it is important for the authorities to engage in a discussion with (potential) market participants about market practices, conditions, and possible impediments.

The relationship between monetary and fiscal policy depends strongly on the development of financial markets. The transition from a rudimentary financial system to a fully developed system can be divided into four stages.<sup>2</sup> In the undeveloped stage, there is no government debt outside the central bank, and fiscal deficits are essentially accommodated by money creation. In the next stage, marketable securities are introduced, but there is no secondary market and interest rates are inflexible. In the transitional stage, a secondary market for government debt instruments exists, interest rates have become more flexible, and central banks conduct more active and independent liquidity management. In the final developed stage, medium-term debt instruments are offered through auctions, interest rates are fully flexible, and central banks control liquidity in the markets through indirect and market-based instruments (e.g., repos). In particular, in the latter two stages, good coordination between the government's financial management (issuance of treasury bills, etc.) and the central bank's monetary policy operations is required.

### **The Role of Central Bankers**

What can central banks do about fiscal policy? First of all, coordination is very important. Even if central banks act on the short end and governments on the long end of the market, their financial activities should be coordinated. Second, communication is key as well. Central bankers expressing views on budgetary policies have become regular features in the international financial press, often in the context of presentations in parliament and at presentations of reports on the economy. Of course, timing and frequency are important elements, and governors are not expected to issue statements each day. The effectiveness of the message will be affected by the stature and image of the governor and his or her institution.

In their messages, central bankers tend to focus on the medium-term sustainability of fiscal policy more than the short-term policies. This includes a focus on a solid and realistic budgetary process that (1) does not require frequent adjustments during the year (which tend to make markets nervous); (2) is based on "conservative" macroeconomic assumptions, in particular with regard to economic growth (a key variable in any budget), but also with respect to interest



rates, exchange rates, and exogenous variables such as energy prices; (3) does not include too many one-off measures and open-ended commitments; and (4) does not imply too many and too frequent fundamental changes in the tax regime (which might create uncertainty and inefficiencies). At the same time, they will focus on the bottom line (i.e., deficits and debt) rather than on the specific line items, to avoid being dragged into a very specific political debate. Last but not least, there appears to be a certain tendency among central bankers to “lean against the wind,” that is, to not be too optimistic when things go well, and not too pessimistic when things take a turn for the worse, but rather to be realistic.

### **Medium-Term Fiscal Frameworks**

In recent years, an increasing number of countries have adopted formal fiscal rules. Central bankers are generally among the proponents of such rules, which can help fiscal authorities better withstand pressures for higher spending and slower fiscal consolidation. The rules, which are often focused on targets for deficits and debt, or on a multiyear spending timeline, are to be embedded in a medium-term fiscal framework based on balanced assumptions for macroeconomic developments.<sup>3</sup>

Fiscal rules can be particularly helpful in cases in which there is no unique counterpart for the central bank, as is the case, for example, in the euro zone, which is also faced with the issue of a new currency that has a limited track record. In order to enforce fiscal discipline and to ensure that national fiscal policies support the stability-oriented monetary policies by the European Central Bank, member countries adopted the Stability and Growth Pact (SGP) as a tool for fiscal policy coordination. The rules of the SGP aim at fiscal sustainability by strengthening fiscal discipline through requirements for budget deficits and debts and medium-term fiscal policy objectives.<sup>4</sup>

### **Transparency**

Finally, incorporating transparency into monetary and fiscal policies is key to their effectiveness. In this context, the IMF has developed two important international standards: the Code of Good Practices on Transparency in Monetary and Financial Policies<sup>5</sup> for central banks and supervisors, and the Code of Good Practices on Fiscal

Transparency<sup>6</sup> for governments. These codes are important instruments to support clarity in discussions on the necessary coordination between monetary and fiscal policy.

## Notes

<sup>1</sup> See Rodrigo de Rato, *Benefits of Fiscal Consolidation*, Presentation to the Real Academia de Doctores (Barcelona, 2004).

<sup>2</sup> See V. Sundararajan, Peter Dattels, and Hans Blommestein, eds., *Coordinating Public Debt Management* (Washington: IMF, 1997).

<sup>3</sup> See Teresa Daban, Enrica Detragiache, Gabriel di Bella, Gian Maria Milesi-Ferretti, and Steven Symansky, *Rules-Based Fiscal Policy in France, Germany, Italy, and Spain*, IMF Occasional Paper 225 (Washington: IMF, 2003).

<sup>4</sup> See Anthony Annett, Jorg Decressin, and Michael Deppler, *Reforming the Stability and Growth Pact*, IMF Policy Discussion Paper, PDP/05/02.

<sup>5</sup> IMF, “Code of Good Practices on Transparency in Monetary and Financial Policies” (2000), <http://www.imf.org/external/np/mae/mft>.

<sup>6</sup> IMF, “Code of Good Practices on Fiscal Transparency” (2001), <http://www.imf.org/external/np/fad/trans/code.htm#>.

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In many countries, central banking was essentially borne out of the need for government to finance the surge of expenditures that accompanied wars.<sup>1</sup>

However, once armed conflict subsided, governments increasingly began to view the monetary authority as a lender of last resort, thus providing some form of financial stability. Nevertheless, the temptation for governments to exploit the monopoly position of central banks in the issue of currency has all too frequently led to excessive inflation, often with disastrous economic and social consequences. The abuse of the central bank by government in order to solve a fiscal problem has been especially notable in developing countries.<sup>2</sup> Economists have long known the potential for conflict arising from the tendency of governments to rely on monetary policy to bail out an excessively loose fiscal policy. Hence, the mantra of price stability that dominates current policy discussions simply represents the revival of an old idea. What is perhaps different today is that governments appear to understand the necessity of promising some form of price stability while central banks in many countries now have the tools to ensure that stable inflation is maintained.

Currently, price stability as an explicit objective for monetary policy is popular,<sup>3</sup> as is the notion that the central bank ought to be autonomous *within* government though not *from* government. Yet, it is not generally recognized that the current state of affairs is the culmination perhaps of a long process through which governments experimented with various strategies to deal with the all-important question of how to define the relationship between the central bank and the executive.<sup>4</sup> This chapter outlines the varieties of existing central bank–government structures. The next section provides a broad characterization of existing models. This is followed by an

explanation of the role of laws versus custom and the limitations of each in helping us understand central bank behavior and performance. Next, a summary is presented of some of the key considerations that have gone into attempts to measure the degree of central bank autonomy and the limitations of such measures. The chapter concludes with a summary, and some policy implications are also drawn.

### **Guiding Principles in Central Bank–Government Relations**

A common element of modern central banking is that such institutions are lenders of last resort, banker for the government, and operate in a fiat money system where the issue of money is monopolized by government. Beyond that, there are wide variations in both the nature of the relationship between the government and the central bank, as well as in the range of responsibilities for the conduct of monetary policy, autonomy from the Treasury, and requirements to supervise the banking system and ensure financial system stability.

As this chapter is intended to provide some insights into the varieties of relationships between the government and the central bank, and the role that autonomy within government plays in influencing the overall performance of the central bank, the present section provides a broad outline of the main links that exist today. To help fix ideas, Table 1 summarizes five key elements that govern the statutory relationship between the executive and the central bank.<sup>5</sup> The objective here is not to provide an exhaustive list of the scope of the relationship between the central bank and the executive. Rather, it is hoped that by identifying some of the key elements we can isolate some aspects of central bank institutional structure that can be related to overall economic performance. Examples are also given of countries that can be thought of as satisfying each of the criteria shown in the table.

**Table 1. Principal Elements in Defining the Central Bank–Executive Relationship**

Type of Representation and Authority of Central Bank Board	Decision-Making Structure at the Central Bank	Type of Government	Place of the Central Bank in Government	Political Structure
Competence, appointment, and supervision EX: Japan	Single EX: Reserve Bank of New Zealand, Thailand	Unitary EX: Reserve Bank of New Zealand, Korea	Organic EX: Mexico	Two-party system EX: U.S.
Regional, appointment, and supervision EX: Germany (pre-ECB)	Single with semiformal assistance from committee EX: Bank of Canada, Bolivia	Federation (weak) EX: U.S. Fed, Malaysia, Mexico	Legislative (difficult) EX: U.S. Fed, Japan	Multiparty system (mixed) EX: Australia
Competence, conduct only EX: ECB, most African and Latin American countries	Committee (closed) EX: U.S. Fed, Mexico, Hungary	Federation (strong) EX: Canada, Argentina	Legislative (easy) EX: Bank of England, African countries	Multiparty system (“Westminster” style) EX: United Kingdom
Mix competence and regional representation, conduct only EX: Canada	Committee (open) EX: Bank of England			Multiparty system (proportional representation) EX: New Zealand

Sources: Individual central banks and author’s interpretation.

Note: EX refers to a country that approximately fulfills the definition appropriate for each cell. A weak federation is one where the power of the regions is small relative to that of the center and vice versa for the case of a strong federation. The interpretation is not restricted to matters of monetary policy alone. An organic law implies that the country’s constitution explicitly defines the role and place of the central bank in governmental institutions. Difficult refers to the legislative hurdles in passing amendments to central banking legislation. Each column is to be treated independently of the other. It is, in principle, possible to mix and match items in each column with items in the other columns.

Generally, two administrative layers govern the operations of most central banks. A supervisory board, referred to here simply as the Board, at a minimum serves to provide some distance between the executive and the central bank either by facilitating the appointments process or by ensuring that the head of the central bank, the governor or the president (hereafter called the CEO), operates within the limits of his or her mandate and does not violate codes of good conduct (i.e., competence). Beyond that, the effective degree of authority of such a Board can vary considerably across countries. Table 1 gives only a taste of the range of the authority such a Board can command in central banks around the world. In particular, the Board may simply reflect the need to guarantee regional representation, often in a federative form of government.

To illustrate, the Board of the Bank of Canada is responsible for recommending the appointment of the governor to the minister of finance.<sup>6</sup> Nevertheless, there is sufficient flexibility in the statutes to make it unclear to what extent the final authority in the matter of appointments rests with the executive as opposed to the Board.<sup>7</sup> Similarly, since Canada is a federation there is, in principle, regional representation even though the statutes do not mandate this.<sup>8</sup> Beyond the appointment of the senior officer of the central bank, the Board has almost no authority. Contrast this with the case of New Zealand where, due to the specific nature of the contract between the central bank and the executive,<sup>9</sup> the Board may be called upon to evaluate whether the CEO of the central bank is in breach of the mandate of the central bank. Indeed, under somewhat controversial circumstances, the Board has been called upon once before to settle a dispute about the performance of the Reserve Bank of New Zealand's governor.<sup>10</sup> Whether or not there is regional representation on the Senior Board of the central bank, there is also some variety in the appointments procedures of such Board. Generally, the executive retains the authority to appoint senior central bank officials. However, in several countries, the appointment may require ratification by the legislature. Viewed in isolation, there seem to be no net benefits in adopting one system over another. In most developing or emerging markets senior appointments at the central bank are made by the executive.

More important is the degree of legislative oversight over the central bank's operations and performance, which is addressed later

in the discussion. A controversial question is whether membership by a government official, almost always as an *ex officio* member, is beneficial. According to the findings of Fry, Goodhart, and Almeida,<sup>11</sup> the presence of a government official on the central bank's Board is a relatively more common feature of the relationship between the central bank and the executive in developing countries. Initially, such membership was believed to contribute to the harmony between fiscal and monetary authorities. More recently, in line with the increased emphasis on the autonomy of the central bank, Board involvement by a government official is believed to represent a constraint on the free flow of discussion among the decision makers within the central bank.<sup>12</sup> Moreover, as transparency and accountability have gained currency as necessary ingredients in delivering good monetary policy, the lines of communication between the central bank and the executive are preferably handled at a more arm's-length level.

The Board's authority is somewhat related to the decision-making structure concerning the implementation of monetary policy. Four types of structures are typically found. Many central banks invest final authority with the CEO over matters dealing with monetary policy. Consequently, these central banks are referred to as single decision-making institutions. A major concern with such a system is that an assessment of the central bank's position and influence may become too closely tied to the personality of the CEO (and perhaps that of the counterpart in the executive, usually the finance minister). This may raise the likelihood of conflict between the government and the central bank.<sup>13</sup> Until recently, the tendency in many developing nations has been to vest authority for carrying out monetary policy with the CEO. Increasingly, however, a committee structure is replacing the single decision-making model. As shown in Table 2, based on data collected in 2004, decision making in a majority of central banks around the world is conducted in a committee structure. The preference for the committee structure is especially notable in the European continent.



**Table 2. International Tendencies in Central Banking Legislation<sup>14</sup>**

Region (Number of countries)	Objective Type				Autonomous		Decision Making		Law
	Price Stabil- ity	Mult + Fin Stabil- ity (FS)	Mult + No FS	P stab + FS	Yes	No	S	C	Or- ganic
Africa (17)	3	6	4	4	4	10	8	9	2
Central and South America (26)	12	1	9	4	16	3	8	15	8
Orient (9)	3	2	0	4	5	1	4	5	0
Europe (42)	36	0	4	2	28	8	4	35	2
North America and Australia (4)	4	1	2	-	3	1	3	1	0

Note: Objective Type refers to the main legislative goal of the central bank; Price Stability need not imply an explicit inflation target; Mult + Fin Stability means that the central bank fulfills several goals (e.g., price stability, economic growth, monetary stability) as well as financial stability as a separate objective; Multi + No FS is the same as the preceding column except no financial stability objective is required; Pstab + FS refers to central banks with a price stability and a separate financial stability objective. S=single decision market; C=committee structure. The definition of committee structure is outlined in the legislation. Informal committee type structures are excluded from the calculations. Column totals need not add up to the total number of countries surveyed if the legislation was insufficiently clear to classify a country's position in the classifications considered.

A variant of the single decision-making structure retains the CEO's authority. However, the central bank's CEO is assisted by a group of experts that provides advice about the appropriate stance of monetary policy.<sup>15</sup> The requirement to seek advice is not in the statutes but the head of the central bank nevertheless resorts to a quasi-formal mechanism to obtain support he or she is legally responsible for implementing. In developing countries, one typically encounters either the single decision-making model or the committee model, but one where the CEO is often *primus inter pares*.

The next two types of decision-making structures formally invest a committee with the ultimate responsibility to carry out the implementation of monetary policy. Such a structure is becoming increasingly common as the public, markets, and even governments demand that central banks, often in exchange for considerable autonomy in carrying out monetary policy, make decisions based on a variety of views. Thereafter, statutes might differ according to the degree of openness with which those deliberations are carried out and publicly announced. In some countries there is limited information provided concerning the position taken by committee members or their voting preferences (e.g., as in the European Central Bank (ECB)). In other countries, votes are announced and positions of committee members are made public (e.g., as in the United Kingdom); the degree of disagreement is usually expressed relying on finely chosen language. It is important to recognize that, in the case of the ECB, it is the sole central bank for a collection of sovereign countries. Hence, “regional” influences will be important in the decision-making process used to carry out monetary policy decisions, not unlike federations where the center is relatively weak.

The makeup of the decision-making structure can be influenced by the overall structure of government. Hence, in unitary states there is no formal recognition of a role for the regions of a country in the statutes. In weak federations, that is, where the power of the central government is large relative to that of the regions or provinces, there may be some formal recognition of regional concerns, perhaps for historical reasons. However, even if regional concerns receive a hearing, central bank decision making is highly centralized. The United States Federal Reserve comes to mind.<sup>16</sup> In other countries relatively few mechanisms exist for regional concerns to have a decisive influence on the conduct of monetary policy (e.g., as in Australia or Mexico).<sup>17</sup> In stronger federations, namely where the relative power of the provinces or regions is significant, there may exist more formal means of providing a role for the regions. The German Bundesbank, prior to the start of European Monetary Union, is one such example. There the German regions, or *Länder*, were given a formal role in the decision-making structure of the central bank, though it was rarely decisive.<sup>18</sup> In other countries, subnational states can directly or indirectly thwart the national government’s ability to interact with the central bank (e.g., as in Argentina).

Next, the legislation governing some central banks is organic, that is, its authority is explicitly defined in a country's constitution. In many other countries, central banking legislation is an act of parliament, with amendments or revisions easy or difficult. In the case of easy changes, the act usually requires a simple majority to implement amendments to the act, for example, as in many parliamentary democracies, such as Canada or New Zealand. Elsewhere, passage of amendments is more difficult either because more than 50 percent + 1 vote is required for passage; the executive's power is restricted by the constitution in such matters (e.g., the United States); or the regions have a powerful legislative voice; or automatic recourse to the judiciary that may limit the executive's ability to shepherd new legislation (e.g., as in Germany). In other countries, no matter whether legislation defining the authority of the central bank is organic or not, it may nevertheless be relatively straightforward for governments to change the constitution because either the judiciary is weak or there is no effective tradition that hinders governmental interference in defining the role of the central bank in national affairs (e.g., in Latin America or Africa). As seen in Table 2 the reliance on organic law to define the constitutional position of the central bank is primarily a feature of Central and South America. Perhaps this result can be partly explained by that region's historically poor inflation record. Indeed, King suggests that: "Countries ... which have not experienced hyperinflation may be more willing to adopt monetary arrangements that are less entrenched in constitutional form ...."<sup>19</sup>

The foregoing considerations suggest that the political structure might also influence, even if only indirectly, the makeup of central bank legislation. The relative autonomy of the central bank may be influenced by whether the political system is a two-party system with a bicameral legislature (e.g., the United States) resulting in appointments being made by the executive but supervision of central bank performance resting with the legislature. Multiparty systems with proportional or mixed representation can conceivably weaken the authority of the central bank if amendments can be easily implemented. More likely, such changes will be difficult to introduce if the legislation governing the central bank has special status requiring a large majority that can be difficult to generate if coalitions are unstable or difficult to build. Finally, in Westminster-style

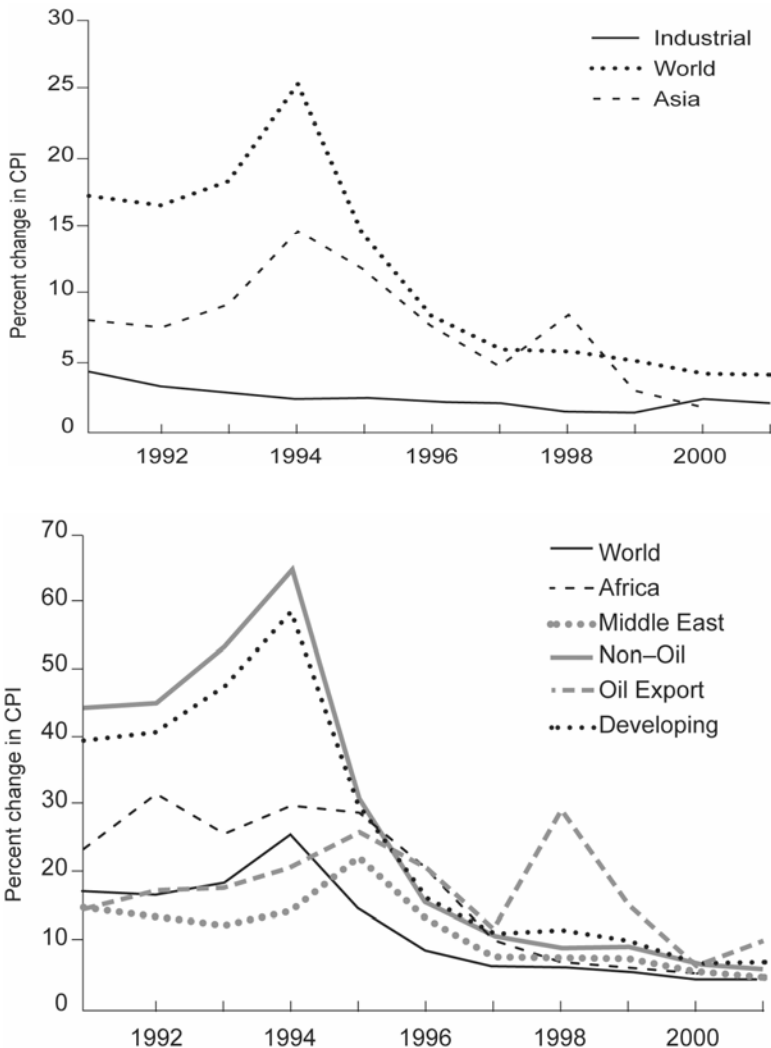
parliamentary democracies (e.g., as in the United Kingdom), the majority party will usually find it relatively easy to implement its preferred central bank structure in principle. In practice, the only exception to this rule is when the government has a minority position in parliament.

All of the above implies that the prime motivation for reforming central bank legislation should stem from government action. While democratic accountability suggests that the government should have the final say about any change in the law, sound practice in defining central bank–executive relations, which includes procedures to minimize conflict over policy questions,<sup>20</sup> should provide for extensive consultations. This too contributes to fostering harmony between the monetary and fiscal authorities. It should be clear from the above that several political forces can shape the overall structure of the relationship between the executive and the central bank. The foregoing also suggests that a variety of central bank structures can accommodate the delivery of good standards in the implementation of monetary policy. The discussion will now turn to the role of explicit versus more subtle aspects of institution building at the central bank.

### **Institutions for Stable Prices: The Role of Laws and Custom**

The most obvious development since the 1990s has been the tremendous convergence in inflation rates across the world, as shown in Figure 1. The disinflation of the 1990s was especially impressive in regions outside the industrial world. A second feature of note has been the narrowing of the objectives of many central banks. Returning to Table 2, the first four columns summarize the objectives of central banks around the world. Price stability as the sole objective of monetary policy clearly dominates overall—a reflection of the change of attitudes about the costs of inflation. As noted previously, comparisons with the 1980s<sup>21</sup> suggest the change is a dramatic one.

**Figure 1. Inflation in Selected Regions of the World: Convergence in the 1990s<sup>22</sup>**



It is useful to note, however, that a possible new trend is emerging, namely the growing reliance on financial stability as a complementary, if not separate, objective of monetary policy. This is not the place to discuss the appropriateness of this development.

Needless to say, however, this new trend is favored by some and criticized by others<sup>23</sup> in part because price stability, if attained, should be conducive to financial stability and need not be treated as a separate objective of monetary policy. The foregoing discussion suggests that the design and performance of monetary policy plays a central role in delivering good economic performance. Indeed, establishing the preconditions for good conduct in monetary policy is now often seen as the litmus test for recognition and trust in international financial circles. There remains, however, considerable diversity in the interpretation of the term “stability.” It is also notable that whenever the objective of the central bank consists of either inflation or an exchange rate objective, the responsibility for setting such an objective is overwhelmingly either a joint one or the sole responsibility of the government.

In contrast, the establishment of a money growth target tends to originate with the central bank. The decline in the popularity of monetary targeting is partly explained by the failure of such a policy to provide clear indications about future inflation and economic growth intentions or expectations of the central bank.<sup>24</sup> As a result, a money targeting policy fails the test of transparency. Also important is the notion that money targeting fails the test of accountability since the central bank typically sets the standards and interprets whether the target has been met.<sup>25</sup> Finally, it is notable that, in several countries, but especially in the nonindustrial world, there is a tendency to view monetary policy as a device that can increase the chances of delivering better aggregate economic performance. An examination of central bank objectives reveals the tendency to water down the price stability objective with potentially conflicting objectives involving support of a government’s economic policy typically intended to mean that the role of the central bank is to assist in stimulating the economy. As we shall see, assuming that monetary policy is about delivering a particular inflation rate, the connection between economic growth and inflation is not easily discernible in a cross section of countries.

Despite some positive developments in the delineation of responsibilities over monetary policy between the executive and the central bank during the 1990s,<sup>26</sup> it is important to underscore the fact that statutory changes in central banking are infrequent and tend to respond to rather than lead developments in the real economy. In

particular, statutes providing a clear division of responsibilities between the central bank and the executive cannot provide a desirable outcome unless there is harmony between fiscal and monetary policies.<sup>27</sup> Indeed, as we shall see in the following section, it remains debatable to what extent central bank independence “buys” lower inflation or better economic performance.

Beyond the need to set clear rules for the central bank to follow, there is the powerful role played by what is referred to in this discussion as “custom.” This is a shorthand term that summarizes the role played by the presence of a free market, a developed financial system, and the presence of stable and respected institutions that are conducive to the maintenance of economic stability. Clearly, the length of time a central bank has been in existence can play a role as such an institution must undergo a learning process and possibly face a series of crises that test its ability to provide stability or a road map back to stability in the aftermath of poor inflation and/or economic performance. The rule of law is clearly another important consideration that helps underscore the ability of the central bank to successfully carry out its tasks with a minimum of interference from the executive. Empirically, it is extremely difficult to summarize all these rather qualitative features that may influence the relationship between the central bank and the executive. Nevertheless, many economists and political scientists have relied in recent years on the Freedom of the World Index of economic and political freedom.<sup>28</sup> In the empirical work that follows, the index ranges in value from 0, indicating perfect or an ideal amount of economic freedom, to 6, indicating a complete absence of economic and political freedom. In addition, there is a relatively large literature that views corruption as having a significant influence on the development and performance of governmental institutions,<sup>29</sup> in particular because corruption affects the functioning of the political system and the likelihood that the rule of law will prevail.<sup>30</sup> The Fraser Institute has also devised an index of economic freedom<sup>31</sup> that combines purely economic variables, such as the size of government or the freedom for capital to move outside the country, along with other indicators of economic freedom.<sup>32</sup>

Why might such indicators be relevant in understanding the role of laws and custom in creating conditions for the development of institutions that can deliver a form of stable prices? As noted above, there is a residual belief implicit in the statutory objectives of many

central banks outside the industrial world to the effect that monetary policy can be a tool to facilitate, if not generate, economic growth via inflationary financing or lax fiscal policies. The degree of corruption also contributes to the likelihood that these types of policies will be adopted. Notwithstanding the hazards involved in estimating a relationship between inflation and economic growth, the fact is that, in a cross section of a large number of countries, it is difficult to find any statistically significant relationship between these two variables even if one controls for regional differences. Some illustrative results are presented in Table 3.

Indeed, even if the cross section of countries is split into two groups, one with average inflation rates in the 1990s of greater than 30 percent, the rest with average inflation rates below that figure, there is still no statistically significant link between these two variables. It ought to be emphasized again that there are several other factors that may explain average economic growth in the 1990s. After all, some of the regressions can scarcely explain more than a quarter of the variation in economic growth over the previous decade. Yet, the results do suggest that if economic growth is not explained by inflation, economic freedom is consistently and significantly a positive influence on economic growth, as reflected in the positive coefficient on the Freedom in the World (Gastil) variable. Similarly, a more corrupt society is reflected in poorer economic performance, as evidenced by the positive coefficient, while measures of central bank independence appear to have no statistically discernible influence on inflation.<sup>33</sup> If economic freedom is maintained or enhanced via low and stable inflation rates then the obvious question is whether inflation performance can best be guaranteed via the granting of autonomy to the central bank. If the answer is in the affirmative then the design of the central bank and its relationship to the executive is a vitally important issue. However, in designing any such institution, policymakers should not lose sight of the fact that the structure and the policies of the central bank need to command public support. In addition, monetary policy, regardless of the institutional structure under which it operates, must operate in harmony with fiscal policy lest the possibility of conflict be raised significantly.<sup>34</sup>



**Table 3. Economic Freedom, Inflation, and Economic Growth in a Cross Section of Countries (1990s)<sup>35</sup>**

Independent Variables	Dependent Variable: Real GDP Growth (percent per year)				Dependent Variable: CPI Inflation Rate (percent)
	89 Countries	89 Countries	Countries with $\pi > 30$ percent only	Countries with $\pi > 30$ percent only (74 countries)	70 countries
Constant	2.20 (.52)*	-0.76 (1.81)	2.13 (.47)*	2.12 (.54)*	-119.38 (184.66)
Inflation <sup>+</sup>	-0.001 (.001)	-0.0002 (.001)	-0.0003 (.002)	-0.0003 (.002)	0.54 (11.61)
Gastil Index	.35 (.16)*	0.39 (.21)*	.51 (.15)*	.37 (.19)*	69.98 (23.47)*
Corruption		0.34 (.19)*			10.39 (20.52)
CBI <sup>++</sup>					-84.67 (215.39)
Regional dummies:					
Africa		1.08 (1.19)		-.53 (1.07)	-174.91 (132.44)
Latin America		2.72 (1.17)*		1.26 (.90)	268.53 (120.57)*
Asia		3.23 (1.13)*		2.04 (1.02)*	-143.10 (123.01)
Emerging European transition economies		-1.09 (1.14)		-1.22 (.91)	168.41 (121.36)
Other		1.61 (1.04)		.55 (.87)	-72.57 (114.87)
<i>Summary Statistics</i>					
R <sup>2</sup>	.06	.34	.13	.28	.35
F(p)	2.26(.08)	435.3 (.00)	5.49(.01)	3.72(.002)	3.64 (.00)

Notes: Estimation is via least squares.  $R^2$  is the coefficient of determination. F is the test for the joint significance of the independent variables with the p value in parentheses. Each column is a separate estimate since the size of the pooled sample is affected by data availability. Data are averages for the 1990–99 sample. \*Statistically significant, at least at the 5 percent level. †Replaced by real GDP growth in the inflation equation. \*\*Index of central bank independence (CBI).

## **The Design of Central Bank Legislation and the Measurement of Central Bank Independence: What Have We Learned?**

In the wake of World War II, monetary policy was clearly being emasculated by fiscal policy. With much of the developed world operating under the quasi-fixed exchange rate system negotiated at Bretton Woods, there was little the monetary authorities could do in the way of practicing autonomous monetary policy.<sup>36</sup>

By the early 1970s, two developments would change the fortunes of the central bank. One was the collapse of the Bretton Woods system that led to the unfettering of exchange rates, especially in the industrial world. The resulting stagflation led policymakers to conclude that inflationary policies were inconsistent with economic growth. Hence, the search began for institutional mechanisms that would prevent the temptation by governments to use the central bank to obtain the fiscal policy they desired.

Around the same time, European policymakers were groping with ways to enhance their economic and political integration. Since outright political integration or federation was not thought to be politically feasible in the short run, the most palatable option was some form of monetary integration.<sup>37</sup> The resulting efforts culminated in the Maastricht Treaty that set out a road map to eventual monetary union and the introduction of the common currency, the euro, in 2002. Since the aspirations inherent in the Maastricht Treaty involved a novel form of economic integration between sovereign states and an autonomous central bank with wide discretion over the implementation of monetary policy—including the decision about how to interpret the mandate to maintain price stability—considerable autonomy was deemed essential.

By the mid-1980s, economists looking back at the record of inflation over the previous decades sought to explain why there were considerable divergences over time.<sup>38</sup> Economists had been interpreting central bank behavior through the device of the reaction function, a mathematical representation of how the central bank changes the instrument of monetary policy, namely an interest rate, to a series of nominal variables such as inflation, and real variables, such as the unemployment rate.<sup>39</sup> Unfortunately, the reaction function approach proved to be a disappointment since, among other drawbacks, it soon became clear that inflation and unemployment are not independent of central bank actions. Hence, the very variables a central bank is supposed to react to are themselves partly determined by how the central bank sets monetary policy. Attempts to quantify central bank behavior fizzled. Instead, many years later, renewed interest in central bank behavior manifested itself in a more qualitative form.

Defining central bank independence as an index ranging between 0 and 1, Cukierman reports a negative correlation with average inflation indicating that more independent central banks generate better monetary policy performance.<sup>40</sup> Several authors would later report a similar correlation based on variants of Cukierman's index.<sup>41</sup> Some would also claim a positive correlation between economic growth and central bank independence<sup>42</sup> though subsequent work would quickly and convincingly dispel the robustness of such a correlation.<sup>43</sup> The index attempts to quantify the statutory relationship between the central bank and the government via the quantification of several key elements in the legislation of the central bank. While space constraints prevent a full discussion here<sup>44</sup> suffice it to say that the index summarizes the impact of the objectives and responsibilities of the central bank, the degree to which it is able to resist instruction from the government, and limitations on the amount and type of lending to the government.

The finding of a significant relationship between inflation and central bank independence had a profound impact on both the economics profession and policymakers more generally. Indeed, some began to wonder whether a simple declaration of independence from the government would represent a “free lunch,” that is, a relatively costless way of generating a needed disinflation. Unfortunately, problems with the qualitative approach began to surface in short order. Here we mention only the ones most germane to the issues

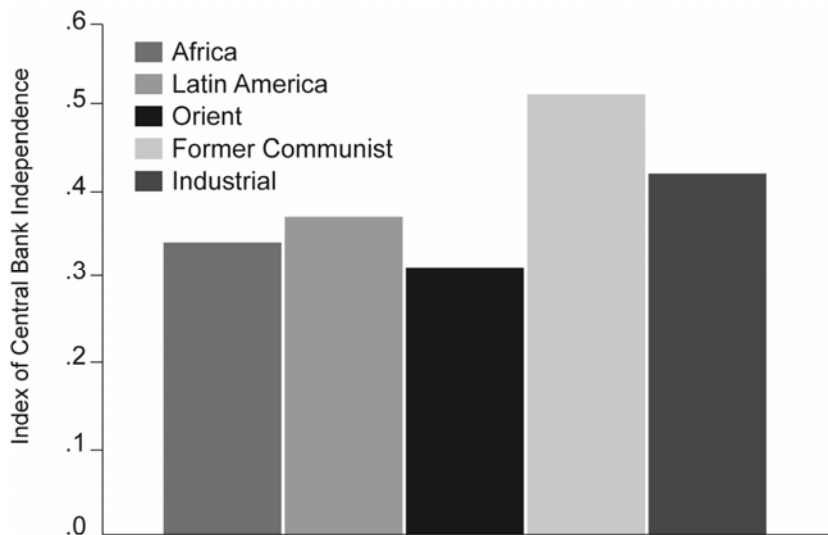
covered in this discussion. First, the benefits of central bank independence did not carry over when a group of less developed countries was considered. Put differently, an index for central bank independence in emerging or developing countries required several modifications to capture special characteristics of the economic systems of such countries.<sup>45</sup> Next, since Cukierman's index is an average of a large number of disparate characteristics of central bank legislation some began to wonder whether some components of the index were more important than others.<sup>46</sup> It was found, for example, that merely codifying the objectives of monetary policy represented a "principal component" of central bank independence.<sup>47</sup> Other authors also began to question whether statutory independence translates into the effective independence. After all, several countries that possessed legislation requiring some form of monetary or price stability were not terribly successful in producing low or stable inflation.

By the mid-1990s, some authors wondered whether the central bank's role in preserving financial system stability and in supervising the banking system—neither characteristic directly considered in the typical central bank independence index—interacted with the goals of independence.<sup>48</sup> For example, the desire to maintain financial system stability might lead an otherwise independent central bank to try for a time to prevent dealing with unsound banking practices. The moral hazard problem inherent in the lender of last resort function might conflict with the goal of financial system stability and possibly inflation. Figure 2 summarizes the difficulties with the index for central bank independence. If we average the overall scores across various regions of the world we find relatively smaller differences in the degree of statutory independence than the record of inflation throughout the 1990s might otherwise suggest. Yet, the convergence in inflation over the past decade, also apparent in Figure 1, may just as well be the reaction to the granting of greater autonomy to central banks around the world. The most striking difference between the industrial countries and the remaining regions is apparent in the degree of corruption, as shown in Figure 3.

Despite the aforementioned drawbacks, the international momentum to grant autonomy to the central bank gathered steam during the 1990s.<sup>49</sup> Greater latitude to conduct monetary policy independent of instructions from the executive led to the recognition that, with greater responsibility, there is a need for accountability. Moreover,

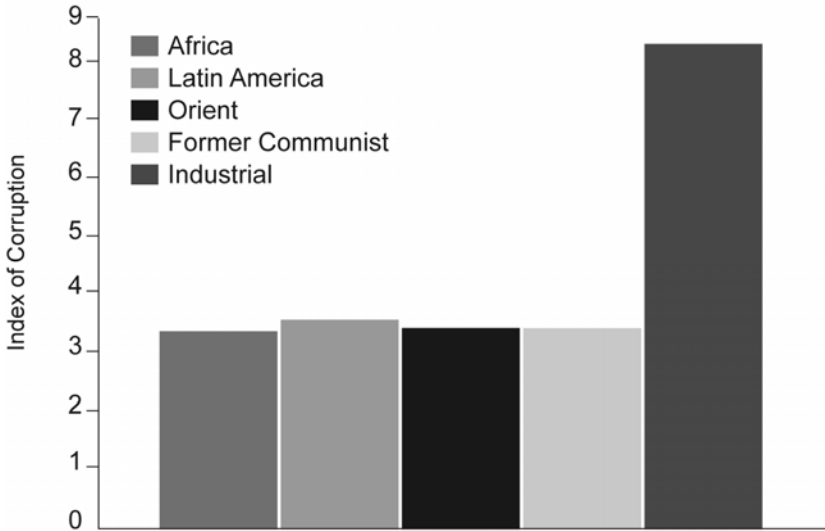
greater accountability creates expectations of more transparency. Therefore, with the battle to grant independence to central banks seemingly won, policymakers turned their attention to giving more precision to the objectives of monetary policy. In particular, if price stability is indeed a desirable objective, then the central bank ought to be accountable for a numerical inflation target range as well as develop policies to explain their actions to the public.<sup>50</sup>

**Figure 2. Central Bank Independence in Various Regions of the World<sup>51</sup>**



The foregoing brief outline of the measurement of central bank independence leads us to draw a few conclusions about the design of central bank legislation applicable to almost any country. The academic literature clearly reveals that there is an important evolutionary aspect in the relationship between the central bank and the executive. Second, the history of central banking during the twentieth century also reveals that conflict and, more importantly, procedures to resolve conflicts between the central bank and government, are crucial to guaranteeing the appropriate amount of central bank autonomy. Finally, achieving harmony between fiscal and monetary policy is a necessary condition to achieve stable inflation and an environment conducive to economic growth.

**Figure 3. Corruption in Various Regions of the World<sup>52</sup>**



### Conclusions

The foregoing overview of the relationship between the central bank and the executive reveals that the recent focus on granting a great deal of autonomy to the monetary authority is a far too narrow one. Domestic political considerations as well as the relationship between domestic and international financial institutions (e.g., the International Monetary Fund) also loom large. In addition, it is also important to recognize the role played by laws and custom. To the extent that some of these characteristics may be country-specific, this suggests that there is no “one size fits all” design for the central bank–executive relationship. Instead, policies ought to be designed to enhance the reputation of the domestic currency and the country’s reputation for financial stability. The evidence presented here suggests that there exists a variety of ways to achieve these objectives.

## Notes

<sup>1</sup> P.L. Siklos, *The Changing Face of Central Banking: Evolutionary Trends Since World War II* (Cambridge, U.K.: Cambridge University Press, 2002).

<sup>2</sup> See, e.g., M. Fry, C.A.E. Goodhart, and A. Almeida, *Central Banking in Developing Countries: Objectives, Activities, and Independence* (London: Routledge, 1996).

<sup>3</sup> See, e.g., B. Bernanke, T. Laubach, F. Mishkin, A. Posen, *Inflation Targeting: Lessons from the International Experience* (Princeton, N.J.: Princeton University Press, 1999); and L. Mahadeva and G. Sterne, eds., *Monetary Policy Frameworks in a Global Context* (London: Routledge, 2000).

<sup>4</sup> See Siklos, *supra* note 1.

<sup>5</sup> Column headings are to be treated as largely independent of each other, at least in principle. Any connection across features of central bank–executive relations are highlighted below.

<sup>6</sup> See Bank of Canada Act, [http://www.bank-banque-canada.ca/pdf/act\\_loi\\_boc\\_bdc.pdf](http://www.bank-banque-canada.ca/pdf/act_loi_boc_bdc.pdf).

<sup>7</sup> A case in point is the process by which the current governor, David Dodge, was appointed. Allegations in the press were made, though not proven, that the finance minister at the time, Paul Martin, insisted that his candidate be selected over the then senior deputy-governor, Malcolm Knight. Whether the allegations are correct or not matters less than the appearance of a weak and subservient Board, which can undermine its authority and effectiveness.

<sup>8</sup> P.L. Siklos, “Charting a Future for the Bank of Canada: Inflation Targets and the Balance Between Autonomy and Accountability,” in D.E.W. Laidler, ed., *Where Do We Go From Here: Inflation Targets in Canada’s Monetary Policy* (Toronto: C.D. Howe Institute, 1997), at 101–84.

<sup>9</sup> The contract is referred to as the Policy Targets Agreement and is renegotiated from time to time, most notably following every election. See <http://www.rbnz.govt.nz/monpol/pta/index.html>.

<sup>10</sup> See Siklos, *supra* note 8.

<sup>11</sup> See Fry et al., *supra* note 2.

<sup>12</sup> International Monetary Fund, *Supporting Document to the Codes of Good Practices on Transparency in Monetary and Financial Policies* (2000), <http://www.imf.org/external/np/mae/mft/sup/index.htm>.

<sup>13</sup> See P.L. Siklos, “Frameworks for the Resolution of Government–Central Bank Conflicts: Issues and Answers,” in *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington: IMF, 2005), at 375.

<sup>14</sup> The information in this table has been assembled using information obtained from individual central bank websites.

<sup>15</sup> *E.g.*, as in Canada’s Governing Council. See <http://www.bankofcanada.ca/en/manage.htm>.

<sup>16</sup> Since there was, historically, a strong emphasis on preventing excessive centralization in all national institutions the structure of the Fed originally reflected this view. Although some aspects of the decentralized structure of the Fed remain to this day, monetary policy has been conducted from the center in the wake of the Great Depression. See, *e.g.*, A.H. Meltzer, *A History of the Federal Reserve* (Chicago: University of Chicago Press, 2003).

<sup>17</sup> *E.g.*, as in Australia or Mexico. Details of the governance of the Reserve Bank of Australia may be found at <http://scaleplus.law.gov.au/html/pasteact/0/310/top.htm>.

<sup>18</sup> S. Lohmann, “Designing a Central Bank in a Federal System: The Deutsche Bundesbank, 1957–1992,” in P.L. Siklos, ed., *Varieties of Monetary Reform: Lessons and Experiences on the Road to Monetary Union* (Boston: Kluwer Academic Press, 1994), at 247–78.

<sup>19</sup> M. King, “Institutions for Monetary Policy,” NBER Working Papers 10400 (April 2004), at 7–8.

<sup>20</sup> See Siklos, *supra* note 13.

<sup>21</sup> See, *e.g.*, A. Cukierman, *Central Bank Strategy, Credibility, and Independence: Theory and Evidence* (Cambridge, Mass.: MIT Press, 1992).

<sup>22</sup> The definitions for “Industrial,” “World,” “Asia,” “Africa,” “Middle East,” “Non-Oil,” “Oil Exporting,” “Developing,” and “CPI” (Consumer Price Index) used in Figure 1 follow the International Financial Statistics (IFS) definition.

<sup>23</sup> D.E.W. Laidler, “Sticking to Its Knitting: Why the Bank of Canada Shall Focus on Inflation Control, Not Financial Stability,” Commentary 196 (Toronto: C.D. Howe Institute, February 2004); and C.A.E. Goodhart, “Some New Directions for Financial Stability,” Per Jacobsson Lecture, Bank of International Settlements (June 2004).



<sup>24</sup> B. Bernanke and F. Mishkin, “Central Bank Behavior and the Strategy of Monetary Policy: Observations from Six Industrial Countries,” in O.J. Blanchard and S. Fisher, eds., *Macroeconomics Annual 1992* (Cambridge, Mass.: MIT Press, 1992), at 183–227.

<sup>25</sup> This led to the phenomenon known as “base drift” whereby the basis on which future money growth targets were established tended to reflect a “bygones are bygones” attitude about targets missed in the past.

<sup>26</sup> See, e.g., Mahadeva and Sterne, *supra* note 3, and Siklos, *supra* note 1.

<sup>27</sup> A point frequently made by former central bankers themselves. See J. Crow, *Making Money: An Insider’s Perspective in Finance, Politics, and Canada’s Central Bank* (London: John Wiley and Sons, 2002); and A. Blinder, *Central Banking in Theory and Practice* (Cambridge, Mass.: MIT Press, 1999).

<sup>28</sup> An explanation of the index, which was formerly known as the Gastil Index, and the methodology used in its construction, can be found at <http://www.freedomhouse.org>. The actual index values used in the empirical work that follows were obtained from M. Paldam, “The Cross-country Pattern of Corruption: Economics, Culture and the Seesaw Dynamics,” 18(2) *European Journal of Political Economy* (2002), at 215–40, and updated from the original data source.

<sup>29</sup> The index of corruption is taken from M. Paldam, “Corruption and Religion: Adding to the Economic Model,” 54(2/3) *Kyklos* (2001), at 383–414. A *higher* value for the index is interpreted to mean a *less* corrupt society.

<sup>30</sup> See, e.g., T. Persson and G. Tabellini, *Political Economics: Explaining Economic Policy* (Cambridge, Mass.: MIT Press, 2000); and A. Drazen, *Political Economy* (Princeton, N.J.: Princeton University Press, 2000).

<sup>31</sup> See Jim Gwartney and Robert Lawson, *Economic Freedom of the World: 1998–1999, Interim Report* (Vancouver: The Fraser Institute, 1998), at <http://www.freetheworld.com>.

<sup>32</sup> The data may be obtained from <http://www.freetheworld.com/download.html>. As the results presented here did not improve with the use of this index, the data were not used in the econometric results to follow.

<sup>33</sup> The same result is obtained for economic growth (not shown). The results do not change if the indicator of central bank independence is replaced with the measure of independence developed by Mahadeva and Sterne, *supra*

note 3, or their measure of the importance of financial stability in central bank objectives.

<sup>34</sup> See, e.g., Siklos, *supra* note 13.

<sup>35</sup> All data are from the IMF's IFS CD-ROM. For further explanation on the countries that make up the regional dummy variables, see *infra* note 51. "Asia" and "Emerging European Transition Economies" are referred to in note 51 as "Orient" and "Old Communist," respectively. The remaining countries are the industrialized nations.

<sup>36</sup> See, e.g., M. Bordo and B. Eichengreen, eds., *A Retrospective on the Bretton Woods System* (Chicago: University of Chicago Press, 1993).

<sup>37</sup> See, e.g., M. Marshall, *The Bank, the Birth of Europe's Central Bank and the Rebirth of Europe's Power* (London: Random House, 1999).

<sup>38</sup> See, e.g., P.L. Siklos, "Inflation Target Design, Changing Inflation Performance and Persistence in the Industrial Countries," 81 *Review of the Federal Reserve Bank of St. Louis* (March/April 1999), at 47–58.

<sup>39</sup> Reuber is credited with introducing this type of analysis of central bank behavior. Dissatisfaction of a technical nature led economists to largely abandon this approach. See G. Reuber, "The Objectives of Canadian Monetary Policy, 1949–61: Empirical Trade-Offs and the Reaction Function of the Monetary Authorities," 52 *Journal of Political Economy* (April 1964), at 109–32. Important developments in econometrics, as well as changes in the manner in which monetary policy is conducted, produced a revival of the reaction function approach that is in full swing today in the form of the so-called Taylor rule. See J. Taylor, "Discretion Versus Policy Rules in Practice," 45 *Carnegie Rochester Conference Series on Public Policy* (December 1993), at 195–214.

<sup>40</sup> Cukierman, *supra* note 22.

<sup>41</sup> See, e.g., Richard C.K. Burdekin and Thomas D. Willett, "Central Bank Reform: The Federal Reserve in International Perspective," 3(3) *Public Budgetary and Financial Management* (1991), at 619.

<sup>42</sup> See, e.g., A. Alesina and L. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," 25 *Journal of Money, Credit and Banking* (May 1993), at 151–62.

<sup>43</sup> J. Forder, "Central Bank Independence and Credibility: Is There a Shred of Evidence?" 3(1) *International Finance* (2000), at 167–85.

<sup>44</sup> See Cukierman, *supra* note 22, Table 19.1.

<sup>45</sup> See, e.g., P.L. Siklos, “Establishing Central Bank Independence: Recent Experiences in Developing Countries,” 4 *Journal of International Trade and Economic Development* (November 1995), at 351–84; and A. Cukierman, G.P. Miller, and B. Neyapti, “Central Bank Reform, Liberalization, and Inflation in Transition Economies—An International Perspective,” 49 *Journal of Monetary Economics* (2002), at 237–64.

<sup>46</sup> See, e.g., K. Banaian, R. Burdekin, and T. Willett, “Reconsidering the Principal Components of Central Bank Independence: The More the Merrier?” 97 *Public Choice* (October 1998), at 1–12.

<sup>47</sup> This type of consideration also led authors such as Debelle and Fisher to draw a distinction between goal independence (i.e., the freedom to choose the effective objective of the central bank) and instrument independence (i.e., the freedom to use whatever means are at the central bank’s disposal to achieve some objective such as an inflation target). See G. Debelle and S. Fisher, “How Independent Should a Central Bank Be?” in J. Fuhrer, ed., *Goals, Guidelines, and Constraints Facing Monetary Policy* (Boston: Federal Reserve Bank of Boston, 1994).

<sup>48</sup> See, e.g., C.A.E. Goodhart and D. Shoenmaker, “Institutional Separation Between Supervisory and Monetary Agencies,” in C.A.E. Goodhart, *The Central Bank and the Financial System* (Cambridge, Mass.: MIT Press, 1995), at 333–413.

<sup>49</sup> See, e.g., Mahadeva and Sterne, *supra* note 3.

<sup>50</sup> See, e.g., Siklos, *supra* note 1.

<sup>51</sup> The index of central bank independence is from Cukierman, *supra* note 22; A. Cukierman, G. P. Webb, and B. Neyapti, “Central Bank Reform, Liberalization and Inflation in Transition Economies: An International Perspective,” Discussion Paper 106, Tilburg University, Center for Economic Research (2000); and Siklos, *supra* note 1. When Cukierman’s index is used, the data are for the 1980–89 period because more up-to-date data are not available. When the Cukierman, Miller, and Neyapti, *supra* note 45 data are used, the data are for the 1990s, as are the index values from Siklos, *supra* note 1.

Regional definitions are as follows:

Africa: Botswana<sup>+</sup>, Cameroon\*, Ghana<sup>+</sup>, Kenya<sup>+</sup>, Malawi\*, Mozambique\*, Namibia\*, Nigeria<sup>+</sup>, Senegal\*, South Africa<sup>+</sup>, Tanzania<sup>+</sup>, Uganda<sup>+</sup>, Zambia<sup>+</sup>, and Zimbabwe<sup>+</sup>.

Latin America: Argentina<sup>+</sup>, Bolivia<sup>+</sup>, Brazil<sup>+</sup>, Chile<sup>+</sup>, Colombia\*, Costa Rica<sup>+</sup>, Ecuador\*, El Salvador\*, Guatemala\*, Honduras<sup>+</sup>, Mexico<sup>+</sup>, Nicaragua<sup>+</sup>, Paraguay\*, Peru<sup>+</sup>, Uruguay<sup>+</sup>, and Venezuela<sup>+</sup>.

Orient: China\*, Hong Kong\*, Indonesia<sup>+</sup>, Japan\*\*, Korea (South)<sup>+</sup>, Malaysia<sup>+</sup>, Philippines<sup>+</sup>, Singapore<sup>+</sup>, Thailand<sup>+</sup>, and Vietnam\*.

Old Communist: Armenia<sup>++</sup>, Belarus<sup>++</sup>, Bulgaria<sup>++</sup>, Croatia<sup>++</sup>, Czech Republic<sup>++</sup>, Estonia<sup>++</sup>, Hungary<sup>++</sup>, Kazakhstan<sup>++</sup>, Kyrgyz Republic<sup>++</sup>, Latvia<sup>++</sup>, Lithuania<sup>++</sup>, Poland<sup>++</sup>, Romania<sup>++</sup>, Slovak Republic<sup>++</sup>, and Slovenia<sup>++</sup>.

Other: Bangladesh\*, Egypt<sup>+</sup>, Greece<sup>+</sup>, India<sup>+</sup>, Israel<sup>+</sup>, Jamaica\*, Jordan\*, Mauritius\*, Mongolia\*, Morocco<sup>+</sup>, Pakistan<sup>+</sup>, Portugal\*\*, Spain\*\*, Tunisia\*, and Turkey<sup>+</sup>.

Industrial: Australia\*\*, Austria\*\*, Belgium\*\*, Canada\*\*, Denmark\*\*, Finland\*\*, France\*\*, Germany\*\*, Iceland<sup>+</sup>, Ireland\*\*, Italy\*\*, Luxembourg<sup>+</sup>, Netherlands\*\*, New Zealand\*\*, Norway\*\*, Sweden\*\*, Switzerland\*\*, United Kingdom\*\*, and United States\*\*.

“\*\*” means that the central bank independence (CBI) is from Siklos, *supra* note 1; “\*” means that no CBI data are available; “+” means that CBI data are from Cukierman, *supra* note 22; and “+++” means that CBI data are from Cukierman, Miller, and Neyapti, *supra* note 45.

<sup>52</sup> The Index of Corruption is based on Transparency International’s Corruption Perceptions Index, where the Index takes values from 0 (very corrupt) to 10 (very clean). The data is based on the work of Paldam. See Paldam, *supra* note 29.

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### **III. SOVEREIGN DEBT RESTRUCTURING**

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SEAN HAGAN

*When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor and least hurtful to the creditor.*

*Adam Smith, Wealth of Nations*<sup>1</sup>

From November 2001 through April 2003, the International Monetary Fund (IMF) and its 184 member countries actively considered a fundamental change in the international financial system.<sup>2</sup> The reform envisaged establishing, through an amendment of the IMF's Articles of Agreement, a treaty-based framework to restructure sovereign debt,<sup>3</sup> referred to as the Sovereign Debt Restructuring Mechanism (SDRM). By the end of a period of intensive discussion regarding the design of the SDRM proposal, a relatively detailed blueprint of the proposal had been endorsed by most Executive Directors of the IMF, evidencing broad support among member countries.<sup>4</sup> However, while support for the SDRM proposal was strong, it was not strong enough. An amendment to the IMF's Articles requires the approval of three-fifths of member countries, holding 85 percent of the total voting power.<sup>5</sup> A number of emerging market countries were opposed to the SDRM proposal, and, by April 2003, the United States, which holds 17.14 percent of IMF voting power, had signaled that it could no longer support the proposal.<sup>6</sup> At that point, the IMF discontinued further work on its development and decided to focus exclusively on more incremental reform measures.

As evidenced by Adam Smith's statement, the notion of establishing some form of insolvency framework for sovereign states is hardly a novel one. The debt crisis that emerged in the 1980s engendered considerable discussion as to whether more forceful



official intervention was needed to resolve creditor coordination issues, and, during the 1990s, various legal reforms were proposed to address growing discomfort with large IMF financing packages.<sup>7</sup> Indeed, although the SDRM proposal was described as a “bombshell” when it was launched by Anne Krueger, First Deputy Managing Director of the IMF, in November 2001,<sup>8</sup> the concept of establishing some form of statutory framework had in fact been considered within the IMF six years earlier.<sup>9</sup>

What distinguished the SDRM proposal from earlier proposals was the extent to which the mainstream of the official sector embraced it. The willingness of so many senior policymakers to support such a major reform was, in part, attributable to their frustration with the lack of progress on the implementation of market-based solutions. Although the official sector had, since 1996, exhorted emerging market sovereigns and their creditors to facilitate the restructuring process by including collective action clauses in their international sovereign bonds,<sup>10</sup> there was still very little to show for it—at least with respect to bonds governed by New York law, which represent by far the largest percentage of international bonds issued by emerging market sovereigns.<sup>11</sup>

The official sector’s decision to give serious consideration to the SDRM proposal was also motivated by the tragedy unfolding in Argentina. By the fall of 2001, there was little doubt that Argentina’s sovereign debt had become unsustainable and that, accordingly, a restructuring was inevitable.<sup>12</sup> While it was understood that any major reform would arrive too late to help Argentina, its circumstances highlighted the need to establish a framework that provided strong incentives for a sovereign debtor and its creditors to engage in the restructuring process at an early stage of a financial crisis—thereby limiting both the economic dislocation for the sovereign and the deterioration in the value of creditor claims.<sup>13</sup> Moreover, the magnitude and complex structure of Argentina’s indebtedness called into question whether a decentralized contractual framework could adequately address the collective action and creditor coordination problems that arise when a sovereign attempts to reach a restructuring agreement with an atomized creditor community.<sup>14</sup>

Finally, in the absence of a sufficiently robust legal framework that addresses these issues in a predictable manner, there was a

concern that the IMF would continue to be under pressure to provide additional financing to countries with unsustainable debt burdens because the alternative path—the restructuring of the sovereign’s debt—was perceived as being fraught with difficulty. As noted by Paul O’Neill, then–U.S. Secretary of the Treasury, in September 2002, “Today, with no clear process for sovereign debt restructuring in place, when a nation is on the brink of financial collapse, we have two stark and uninviting options—unwarranted lending or sending the nation off a cliff into a catastrophic default.”<sup>15</sup>

Whether interest in the SDRM proposal—or some other treaty-based framework—will reemerge within the official sector will depend on a number of factors, including the frequency of financial crises and the extent to which alternative, contractual-based frameworks are able to limit their severity. In the immediate term, however, one of the tangible benefits of the SDRM initiative is that market participants and emerging market sovereigns have finally agreed to include collective action clauses in their debt instruments. It would appear that a credible threat of official intervention prompted this degree of self-regulation.

This chapter discusses the underlying rationale for the SDRM proposal, its key features, and the lessons that can be distilled from the vigorous debate that it engendered. The first section discusses the motivations for reform. As will be seen, perceptions vary as to the nature of the weaknesses of the existing system. Not surprisingly, these differences define the contours of any discussion of the design of a new legal framework. The second section analyzes the key issues that arose in the design of the SDRM proposal—many of which will be of relevance to any type of statutory sovereign debt restructuring framework that may be considered in the future. The discussion concludes by setting forth some general observations as to the nature of the resistance to the SDRM proposal and the possible implications of this resistance to any future reform efforts.

The SDRM proposal was developed in the open. At each stage of its evolution, the IMF staff papers outlining the various issues and design options and the IMF Executive Board’s views of these papers were published.<sup>16</sup> The financial press followed the SDRM proposal’s development closely; many editorial pages gave positive reviews. At the same time, the press observed that the SDRM proposal would

continue to face significant political obstacles in attempting such ambitious reform.<sup>17</sup> The feedback from legal and economic scholars, workout practitioners, nongovernmental organizations, and market participants helped shape subsequent versions and sharpened everyone's understanding of the issues, not least that of the IMF's staff.<sup>18</sup> Not surprisingly, the analysis contained in this chapter has benefited considerably from this engagement.

### **Defining the Problem**

While there is an emerging consensus that the crisis-resolution framework is in need of reform, views differ as to why. For example, many actors in this area, including the IMF, have emphasized that difficulties in securing collective action among a large and diverse group of private creditors unnecessarily delay the restructuring process, thereby increasing the costs for both the sovereign debtor and its creditors.<sup>19</sup> While the private sector has acknowledged that the evolution of capital markets has exacerbated collective action difficulties, these actors point to debtor behavior as the primary barrier to restructuring. For example, they complain that sovereign debtors have, to date, sought, and in some cases achieved, restructurings through unilateral take-it-or-leave-it exchange offers where investors lack sufficient information to make informed decisions regarding such offers.<sup>20</sup> More generally, once a crisis arises, it may be argued that the principal reason why the restructuring process may be slow and costly for all concerned is the debtor country's inability to elaborate and implement appropriate corrective policies.

Separately, a number of observers within the official sector and academia see the IMF's lending practices as the key shortcoming of the existing framework. There appear to be two related concerns. The first is that, in the absence of a predictable and transparent set of rules governing access policy, neither debtors nor creditors can assess the timing of when a restructuring is unavoidable.<sup>21</sup> In these circumstances, the sovereign is tempted to "gamble for resurrection" with the willing participation of its private creditors. The second concern is that, more generally, the availability of IMF financing not only delays the restructuring process, but also conspires to create the crisis in the first place. Specifically, there is a view that IMF lending creates "moral hazard"; in other words, by shielding creditors from the risks

that they should bear, IMF financing encourages imprudent lending, thereby increasing both the likelihood and severity of future financial crises.<sup>22</sup>

This section examines the relative merits of these concerns and the extent to which the perceived—and actual—weaknesses in the system are interrelated. In some respects, the complexity of the issues highlights the degree to which legal reform will never be a panacea. In particular, while a legal framework can help shape the incentives of a sovereign when it considers how and when to restructure its debt, it cannot substitute for coherent economic policies or for the political will that such policies require.

### **Collective Action Problems**

As demonstrated on numerous occasions over the last seven years, circumstances arise where a sovereign's debt becomes "unsustainable"; that is to say, where the resolution of the crisis requires a reduction of the net present value of the sovereign's liabilities, rather than just a reprofiling of maturities. Of course, making judgments as to when the problem facing the sovereign is one of illiquidity—where a rescheduling would be sufficient—rather than one of unsustainability is hardly an exact science. A company is "insolvent"—rather than just illiquid—when the value of its liabilities exceeds its assets. In the case of a sovereign country, such a concept is of limited relevance. By virtue of its sovereign authority and, in particular, its fiscal powers, a country's assets are theoretically inexhaustible. For this reason, an assessment of debt sustainability requires not only a judgment as to whether, for example, the projected primary fiscal surplus is sufficient to cover forthcoming debt payments, but also whether, as a political matter, such a surplus can actually be achieved and sustained.<sup>23</sup>

Notwithstanding the difficulties in making assessments of unsustainability, there will be situations where there is no feasible set of sustainable macroeconomic policies that would enable the country to resolve the crisis and regain medium-term viability without a significant reduction in the net present value of its debt. In these circumstances, it is in the interests of both the sovereign debtor and its creditors to reach a restructuring agreement that provides for sustainability as soon as possible. At that point, however, the question

arises as to whether the ability to reach such an agreement is hampered by failures in collective action. More specifically, the parties must determine and measure the risk that individual creditors will decline to participate in a restructuring in the hope of recovering payment on the original contractual claims, even though creditors—as a group—would be best served by agreeing to a restructuring as soon as possible. If the perceived risk is significant, creditors may be unwilling to participate in the restructuring because of inter-creditor equity concerns. In such an uncertain environment, debtors would be understandably nervous about initiating the restructuring process.

For financially distressed companies, the problem of collective action is a form of market failure that provides one of the principal justifications for official intervention, normally through the establishment of liquidation and corporate reorganization laws.<sup>24</sup> However, the collective action problems that arise in the sovereign context are of a rather special nature, and an understanding of them requires an analysis of the recent evolution of the financial and legal environment within which sovereigns borrow and, on occasion, default.

### ***Developments in the Sovereign Debt Market***

Over the years, the dynamics of the sovereign debt restructuring process have been shaped not only by the nature of the claims against the sovereign but also by the identity of the creditors holding the claims. During the 1980s, most of the debt being restructured was made up of syndicated commercial bank loans and a structured collective negotiating framework that was generally implemented through the operation of bank steering committees.<sup>25</sup> While the sovereign was often in default during the restructuring period, litigation was not common and, more generally, the process was relatively predictable.<sup>26</sup> Moreover, the banks in question often provided new financing to the sovereign during the restructuring period. While the willingness of banks to participate in such a framework was attributable to a number of reasons, two factors were particularly important.

First, as regulated institutions, banks acted under the influence of the official sector, which had a strong desire to ensure that the restructuring process proceeded in an orderly fashion. This influence

was exercised through a combination of moral suasion and the rather generous implementation of provisioning regulations. Second, since banks had extensive business with both the sovereign borrowers and their residents, they had a strong interest in behaving in a manner that did not undermine these long-term relationships.

The process was not free of difficulties, however. During the early stages of the 1980s debt crisis, the official sector's ability to exercise influence over the process was, in large part, due to the financial vulnerability of the creditors. Given their exposure in these countries, the banks needed some degree of forbearance from their regulators. By the end of the 1980s, however, the balance sheets of the commercial banks had improved to the point where they had sufficient loan-loss provisions to enable them to write down the value of their loans. Under these circumstances, they became increasingly reluctant to continue to participate in the restructuring.<sup>27</sup> Moreover, while litigation was rare, there were cases in which banks refused to participate in the negotiating process and opted for enforcement through the court system.<sup>28</sup>

With the emergence of bonded debt as the primary source of financing for emerging market sovereigns during the 1990s, the restructuring process has become considerably less predictable. As a result of disintermediation, the creditor community has become relatively atomized, and, as a result, creditor coordination problems are far more pronounced. Perhaps more importantly, creditor incentives have been transformed by the liquidity of these instruments. Institutions that purchase emerging market sovereign bonds on the secondary market—purchases made at a discount due to emerging stresses on the instruments—are often unregulated and, accordingly, are not subject to the influence of the official sector. Moreover, as creditor purchasers as opposed to credit providers, these institutions will often have no long-term business relationship with the borrower. Rather, they approach the restructuring process with singular interests: they seek to maximize the value of the claims they possess at the time.

In some circumstances, a distressed debt purchaser's objective of maximizing value can work to the advantage of the sovereign debtor: a creditor that has purchased a claim on the secondary market at a deep discount may be far more willing to agree to a reduction in the

face value of the claim than a creditor who purchased the claim at face value. However, such creditors may also choose not to participate in a restructuring that has been agreed upon by most creditors, with a view toward extracting more favorable terms from the borrower.<sup>29</sup> Indeed, the very possibility that some creditors may hold out for more favorable negotiable terms can make it far more difficult for more cooperative creditors to reach a settlement with the debtor. Concerns regarding inter-creditor equity will be exacerbated when they also have fiduciary obligations to end-investors, a situation that has become increasingly common with the repackaging of financial instruments.

### ***The Legal Environment***

Whether the existence of holdout creditors generates a collective action problem of such a magnitude that it undermines the capacity of a debtor and its creditors to secure a rapid restructuring agreement will depend on whether the holdout strategy is perceived to be credible. In the sovereign context, how likely is it that the holdout creditor will have sufficient leverage against the sovereign to extract preferential terms? Assuming the sovereign is in default, the answer turns on the ability of the holdout to legally enforce its claims.

For a creditor wishing to enforce its claims against a sovereign, obtaining a judgment is no longer a particularly onerous task. The traditional concept of absolute sovereign immunity has been significantly eroded over the years under the laws of those jurisdictions that typically govern international debt instruments.<sup>30</sup> Perhaps even more importantly, these jurisdictions will give effect to those contractual provisions that include a broad waiver of these immunities. In the United States, for example, the Foreign Sovereign Immunity Act (FSIA) enables a court to exercise jurisdiction over a sovereign where it has waived explicitly or implicitly its immunity from suit,<sup>31</sup> or where the action (1) is based on commercial activity carried on in the United States by the foreign state, (2) is based on an act in the United States in connection with commercial activity outside the United States, or (3) is taken in connection with commercial activity carried on outside the United States that causes a direct effect in the United States.<sup>32</sup> Bonds issued by emerging market sovereigns that are governed by New York law typically provide for a comprehensive waiver of sovereign immunity, including immunity

from suit, prejudgment attachment, attachment in aid of execution, and execution. Moreover, where an express waiver of immunity from suit is absent, the commercial activity exception has been interpreted to include circumstances where the sovereign has issued debt in a public marketplace and where its breach of a U.S. dollar debt obligation has caused a direct effect in the United States.<sup>33</sup> What of the substantive defenses available to a sovereign that finds itself subject to the jurisdiction of a foreign court? While they exist, recent litigation demonstrates that they have been narrowed considerably.<sup>34</sup>

But while a creditor may obtain a judgment against the sovereign with increasing predictability, its ability to collect on that judgment is still somewhat uncertain. For a variety of reasons, the assets of a sovereign that are available to a judgment creditor are rather limited.<sup>35</sup> First, even if the debt agreement provides for a broad waiver of sovereign immunity with respect to the attachment of assets, the laws of the sovereign will generally prevent a judgment creditor from seizing assets of the sovereign located within the sovereign's territory.<sup>36</sup> Second, not all assets located outside the sovereign's territory are available for attachment. For example, under the FSIA, only property of a foreign state "used for a commercial activity in the United States" is available for attachment.<sup>37</sup> It has generally been understood that diplomatic property is protected, even where the waiver contained in the contract is very broad.<sup>38</sup> Third, under the FSIA, the assets of an agency or instrumentality of the sovereign will normally not be available to satisfy a judgment against the sovereign.<sup>39</sup> Most importantly, perhaps, the reserves of the central bank—a potentially attractive target for a judgment creditor—will normally not be available for attachment unless the central bank is also liable under the terms of the debt instrument.<sup>40</sup>

Faced with the difficulty of locating assets of a sovereign debtor that are subject to execution, judgment creditors have developed an alternative strategy that involves seeking injunctive relief to interrupt the servicing of debt held by other creditors. The most celebrated—or notorious—case in this regard involved a successful collection effort by a distressed debt purchaser (Elliott) against the Republic of Peru. In that case, Elliott relied on a *pari passu* provision in the debt to obtain an ex ante order from a Brussels court preventing Euroclear from accepting an interest payment from Peru on its Brady holders of



the bonds, thereby preventing Peru from servicing its restructured debt.<sup>41</sup>

Commentators have raised questions regarding the legal basis for the injunctive relief granted by the Belgian courts in these cases.<sup>42</sup> In *Elliott*, the relevant agreement held by the distressed debt purchaser contained a *pari passu* provision, which the distressed debt purchaser argued precluded Peru from making payments to the Brady holders unless a ratable and simultaneous payment was made to Elliott, and that this obligation should be enforced through injunctive relief.<sup>43</sup> It has been argued that this is a novel and overly expansive interpretation of a contractual provision that has generally been understood to limit the legal subordination of debt, but has not been read to preclude the making of payments to certain creditors or to require the simultaneous and ratable payment of debt to all creditors.<sup>44</sup> In the context of the litigation arising from Argentina's default on its external debt, the U.S. government, the New York Clearing House Association, and the Federal Reserve Bank of New York have emerged as new critics of this expansive definition of the *pari passu* provision. Each filed a submission supporting Argentina's claim that a narrow interpretation of the *pari passu* provision should be recognized.<sup>45</sup> It was also argued that the *pari passu* provision—whatever its interpretation may be—cannot be relied upon by a judgment creditor as a means of enforcing rights under a contract reduced to judgment because, under the doctrine of merger—long accepted under New York law—a judgment creditor no longer retains the contractual rights that it possessed prior to obtaining a judgment and, therefore, may not normally invoke provisions such as the *pari passu* provision when seeking relief before the court.<sup>46</sup>

As of the date of publication of this piece, the New York court presiding over the Argentine litigation had not yet ruled on either the scope or relevance of the *pari passu* provision for creditors that may seek to enforce their claims against Argentina. In the context of the litigation involving Nicaragua, however, the Court of Appeals of Brussels refused to use the *pari passu* provision as a means of preventing sovereigns from making payments through the settlement system. Reversing the order of the lower court that had enjoined Euroclear from Nicaragua's interest payment to its bondholders, the Court of Appeals concluded that a violation by the sovereign debtor of its contractual obligations to a creditor should not lead to a third

party (in this case Euroclear) being held responsible in any way for the violation.<sup>47</sup>

Even if the past-judgment enforcement of a *pari passu* provision is unlikely to provide a durable basis for this enforcement strategy, that does not necessarily signal its demise. In the context of an enforcement action brought by a distressed debt purchaser against the Democratic Republic of the Congo, a federal district court in California issued an order that limited the ability of the sovereign debtor to make payments to its creditors absent satisfaction of the judgment or the making of ratable payments to the judgment creditor.<sup>48</sup> While the judgment creditor had sought this relief on the basis of the *pari passu* provision contained in the loan agreement, the order issued by the court reveals that the court denied specific performance of this provision.<sup>49</sup> Although the record is silent on the question, the court's reluctance to grant the request on the basis of the *pari passu* provision may have been due to its concern that the doctrine of merger precluded a judgment creditor from relying on a contractual provision for this purpose. Nevertheless, the court clearly took the view that—as a means of providing relief to a judgment creditor—it had the authority to fashion relief that had the same effect as an order based on a broad interpretation of the *pari passu* provision.<sup>50</sup>

As long as this enforcement strategy—whatever its legal basis—continues to be sufficiently credible, it will undermine the debt restructuring process in at least two respects. First, by making the holdout strategy more effective, holdouts may multiply. For inter-creditor equity reasons, creditors that were otherwise inclined to accept the terms of the restructuring may be less likely to do so. Second, since a key feature of the holdout strategy may be interruption of the sovereign's payments to other creditors, those creditors that are considering whether to accept the restructuring offer may think twice if they perceive a risk that the sovereign may be unable to service the debt to be restructured.

### ***The Pre-Default Problem***

The above analysis has assumed that the sovereign has defaulted on its financial obligations before it approaches its creditors regarding a restructuring. In these circumstances, any analysis of the nature and

the extent of the collective action problem necessarily focuses on the ability of the holdout creditor to extract preferential treatment through the legal enforcement of its claim. But what of collective action problems that may arise before the occurrence of a general default and the onslaught of a full economic crisis?

From the perspective of the sovereign, the crisis triggered by a default will cause considerable dislocation in the financial system and the economy more generally. For example, if the sovereign's banks hold a significant amount of the claims that are in default, the loss in value of these claims can create an insolvent banking system. More generally, the disruption in debtor-creditor relations arising from a default can precipitate capital flight and a sharp decline in private investment. Such economic dislocation will have negative feedback effects for creditors; to the extent that a full-blown crisis leads to an insolvent banking system, the eventual need to recapitalize this system will divert/consume fiscal resources that could otherwise have been used to service the restructured debt (i.e., it will only deepen the debt relief that is needed to ensure sustainability).

Ironically, while the sovereign and its creditors have a strong interest in securing a restructuring prior to default, the collective action problem may be most acute during this pre-default period. A creditor facing the decision whether to accept the terms of a restructuring offer prior to default will find the holdout option particularly tempting; if the restructuring goes forward, it will not have to sue the sovereign, opting instead, perhaps, to wait in anticipation that its unstructured claim will continue to be serviced. This anticipation will be well-placed if a sufficient number of creditors agree to the restructuring. In these circumstances, the sovereign will have been able to engineer and achieve a sustainable debt burden and will be tempted to continue to service the claims of the holdouts so as to avoid the reputational implications of a default. Of course, if most creditors adopt this strategy, there will not be sufficient participation to achieve a sustainable debt burden.

### ***The Existing Tools: Collective Action Clauses***

Much of the discussion regarding both the need for and design of reform centers around the question of whether a legal framework based on contract would be sufficiently robust to neutralize the types

of collective action problems described above. More specifically, could one rely on the collective action clauses that are typically found in certain types of international sovereign bonds and simply take the step of ensuring that they are included in all such bonds—particularly those governed by New York law, which continue to constitute the largest portion of emerging market bond issuances?<sup>51</sup>

Although the terms of collective action clauses vary, they normally include two types of provisions. Perhaps the most important is the provision that enables a qualified majority of bondholders (typically 75 percent) to bind all bondholders within the same issue to the financial terms of a restructuring, either before or after a default. This provision—a “majority amendment” or “majority restructuring” provision—is typically included in sovereign bonds that are governed by the laws of either England or Japan.<sup>52</sup> Until very recently, however, they have generally not been included in bonds governed by the laws of New York.<sup>53</sup> As of the date of this publication, they still do not exist in bonds governed by German law.<sup>54</sup> The second type of provision, the “majority enforcement” provision, is designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claim after a default but prior to a restructuring agreement. Two elements of this provision can already be found in bonds governed by English and New York law: (1) an affirmative vote of a minimum percentage of bondholders (typically 25 percent) required to accelerate claims after a default; and (2) a simple or qualified majority can reverse an acceleration after the default—on the originally scheduled payments—has been cured.<sup>55</sup> Trust deeds governed by English law contain an even more effective type of majority enforcement provision: under this structure, the right to initiate legal proceedings on behalf of all bondholders is conferred upon the trustee, who is required to act only if, among other things, it is requested do so by the requisite percentage of bondholders (typically more than 25 percent).<sup>56</sup> As a consequence of the trustee’s authority to initiate legal proceedings on behalf of all bondholders, any amounts recovered by the trustee through such proceedings are for the benefit of all of the bondholders and therefore must be distributed pro rata among them.

Experience demonstrates that collective action clauses can play an important role in facilitating the restructuring process. When Ukraine restructured its debt in 1999, its use of the majority

restructuring provisions was an important reason why it was able to achieve a participation rate of 99 percent of creditors.<sup>57</sup> Similarly, in the context of its successful debt exchange operation, Uruguay used a majority restructuring provision to restructure its Samurai bond.<sup>58</sup>

Until recently, one of the major problems of relying on a legal framework based on collective action clauses has been the difficulty of actually putting such a framework in place. In a seminal 1996 report, senior representatives of the leading 11 industrial countries set forth a number of recommendations to strengthen the framework for crisis resolution. While it considered the desirability and feasibility of establishing some form of statutory framework for the restructuring of debt, it concluded that it would be far more practical to resolve problems of collective action and creditor coordination through the inclusion of collective action clauses and recommended that majority restructuring provisions be included in all bonds governed by New York law.<sup>59</sup>

For eight years, however, the market largely ignored this call: bonds issued in New York continued to represent the instrument of choice for emerging market sovereigns, and very few such bonds contained these provisions.<sup>60</sup> From early 2003 onward, however, majority restructuring provisions have become standard in bonds governed by New York law.<sup>61</sup> As recognized by a number of commentators, this important breakthrough was attributable to concerns among both market participants and emerging market issuers that, absent some demonstrable progress in this area, there was a greater likelihood that the official sector would proceed with more forceful intervention, that is, the establishment of some form of statutory debt restructuring framework.<sup>62</sup>

Now that collective action clauses have become a standard feature in new international sovereign bond issuances, the most important outstanding question is whether a framework based on contract will prove to be sufficiently robust to address the type of collective action problems that arise in the current environment. If one concludes that collective action problems are exacerbated by the multiplicity of instruments issued in different jurisdictions, the question arises as to whether traditional collective action clauses—which only bind bondholders within the same issuance—will prove to be sufficiently robust.<sup>63</sup> Provided that a holdout creditor acquires a

sufficient percentage of a particular issuance, it can effectively neutralize the operation of the collective action clause in that issue. In these circumstances, creditors holding other issuances may not be willing to restructure their own instruments because of their inability to ensure that the “holdout issue” will be bound by the same terms.

In some respects, the ability of a creditor to obtain such a blocking position is facilitated by the liability management operations that are conducted by emerging market sovereigns on a periodic basis. To avoid the bunching of maturities, an issuer will often exchange existing instruments for new bonds with slightly longer maturities. Since not all of the original instruments will be tendered in such exchanges, these operations will often leave behind relatively small residual amounts of the original issue. Creditors may easily purchase a controlling position in these “orphan” issuances in anticipation of a future restructuring, at which time they may try to use this position as leverage for preferential terms.

Theoretically, bonds issued under trust deeds could undermine such a multiple-instrument holdout strategy. As discussed above, such a structure creates a *de facto* sharing arrangement inasmuch as proceeds recovered by the trustee through litigation are distributed *pro rata* among all bondholders. Accordingly, even if a bondholder wishing to pursue litigation has managed to acquire a sufficient percentage of bonds to enable it to instruct the trustee to initiate legal action (25 percent of outstanding principal is normally required), the *pro rata* distribution of any amounts recovered among all bondholders in the issuance will act as a disincentive for the controlling bondholder to pursue this route.<sup>64</sup> As a matter of practice, however, this disincentive may be more apparent than real. Even when bonds contain collective action clauses, it is very likely that restructurings will continue to involve an exchange of instruments when, as a condition for tendering the bonds, a bondholder must first agree to amend the terms of the bond being exited so that the payment terms are consistent with the bond it is accepting. This is the approach followed in the case of Ukraine and is designed to enable the sovereign to increase the liquidity of its external debt by reducing the number of issuances outstanding.<sup>65</sup> The difficulty with this approach from a collective action perspective is that it may result in a residual bond issuance that would have effectively been emptied out through

the exchange, leaving a controlling holdout that would only be required to share with itself.

The potential problems arising from a large number of debt instruments are not necessarily limited to the multiplicity of different bond issuances. Given the evolution of capital markets, for example, it can no longer be assumed that the restructuring of syndicated bank debt will be an orderly one. While in the 1980s commercial banks generally refrained from litigation, the growing securitization of these claims means that they can now be easily purchased by vulture creditors that specialize in these techniques. In recognition of this fact, the official sector has advocated that syndicated bank loan agreements also include collective action clauses.<sup>66</sup> However, such a framework will face the same limitation: a restructuring could be undermined where a number of different syndicates and bond issuances (all of which contain collective action clauses) are reluctant to participate in the restructuring because another bank syndicate is controlled by a holdout creditor.

There is not yet sufficient experience to draw firm conclusions as to the dimensions of the above problems. However, the potential benefits of a framework that aggregates claims for voting purposes are recognized even among those that oppose a statutory framework and have led to a discussion of whether one could achieve some degree of aggregation under contract.<sup>67</sup> Indeed, in the context of Uruguay's recent exchange of instruments, a first—albeit small—step was taken in that direction. In the context of a bond exchange achieved in 2003, Uruguay issued a number of different bond series under a single trust indenture.<sup>68</sup> The terms of the trust indenture included an innovative voting clause that gave the sovereign the option of aggregating voting across the affected bond series (which could include new series). Specifically, the traditional 75 percent majority needed for changing payment terms on an individual bond issuance was lowered to 66⅔ percent, provided that at least 85 percent of the aggregate outstanding principal of all issuances to be affected support the amendment.

Of course, this aggregation feature has two important limitations. First, while the required 66⅔ percent threshold for each individual series is easier to achieve than the typical 75 percent, it still enables a creditor to obtain a blocking position with respect to particular

issuances, albeit with greater difficulty. Second, the aggregation would only apply to new bonds governed by New York law that are issued under the same trust indenture. Would it be possible, through contract, to aggregate claims of instruments that are governed by different laws or different jurisdictions? In the event that a dispute arose regarding the application or interpretation of the voting provisions, there is a risk that holders of different bond issues would find themselves in different courts—which could provide different interpretations. How serious a problem this would be would depend on whether the sovereign issuer chooses to issue in different jurisdictions.

A very different question regarding the durability of a contractual framework relates to its application to a judgment creditor. As noted earlier, it has been argued that the doctrine of merger that is well accepted under New York law normally precludes a judgment creditor from relying on the underlying contractual provisions—including a *pari passu* provision—when seeking to enforce its judgment, the law of merger in England being substantially the same.<sup>69</sup> The reverse side of this doctrine, however, is that it may also preclude a sovereign and a qualified majority of bondholders from using a collective action clause to restructure the claim of a bondholder that has already obtained a judgment against the sovereign on the basis of that contractual claim. Because the bondholder's claim has now been reduced to a judgment, it no longer has a contractual claim against the sovereign and, therefore, should be immune from any amendments that are affected with respect to any contractual claims. Of course, the ability of a creditor to obtain a judgment for the purpose of insulating itself from the operation of a majority restructuring provision will be complicated if the bond also contains a majority enforcement provision that limits the ability of the creditor to accelerate and or to initiate legal proceedings in the first place.<sup>70</sup> Moreover, the question also arises as to whether it would be feasible to design a collective action provision in a manner that would enable it to survive the entry of judgment, similar to those provisions of contracts that address enforcement of judgments, such as waivers of sovereign immunity.<sup>71</sup>



### **The Role of IMF Financing**

No matter how orderly and rapid the restructuring process can be made, it is still likely to be a painful one for the sovereign. The economic dislocation caused by the restructuring process will often be severe, and, as can be expected, the associated political costs will be foremost in the minds of government officials. Because the concept of debt sustainability in the sovereign context is necessarily probabilistic, a minister of finance will often be able to convince himself or herself that a restructuring—no matter how likely it may seem to an outside observer—can be avoided if certain additional adjustment measures are taken and additional financing obtained.<sup>72</sup> Yet these delays—and the contortions that the economy is put through while the government gambles for resurrection—are likely to reduce the available policy options when the crisis eventually arrives and, more generally, exacerbate the economic dislocation that occurs when the country is forced to default. This dislocation may include a severe decline in output and real incomes, a reduction in investment, distress within the financial sector, and a drain in foreign exchange reserves.

In light of the above, how can sovereigns be encouraged to restructure unsustainable debt earlier rather than later? Providing a sovereign debtor with the legal tools to resolve collective action problems may give it greater confidence that it can attract a critical mass of creditor support for the restructuring, but the economic costs of restructuring may mean that the availability of these tools alone is unlikely to push authorities to initiate the restructuring process. Rather, a sovereign is most likely to initiate the restructuring process only when it understands that it will no longer receive financial support from the IMF unless it does so. In recognition of this fact, many are of the view that the area where greatest reform is needed is the design and application of the IMF's policy on the availability of its financial resources.<sup>73</sup>

Any assessment of the role of the IMF in the resolution of crises—and of the criticisms of this role—requires both an analysis of the legal basis for the IMF's financial assistance and an understanding of the types of problems that countries have been facing when they approach the IMF for this assistance. One of the general purposes of the IMF is “to shorten the duration and lessen the degree of

disequilibrium in the international balance of payments of members.”<sup>74</sup> When the IMF extends financial assistance to a country, it must satisfy itself that two conditions have been met. First, the IMF’s Articles of Agreement require that its resources may only be used for the purpose of helping a country resolve its balance of payments problems.<sup>75</sup> For this reason, the IMF must be of the view that the country in question is implementing policies that will address—rather than simply delay—the resolution of its external difficulties. Second, the IMF must also have assurances that the country will be in a position to repay the IMF within the relatively short period required under the Articles.<sup>76</sup> The primary policy tool used by the IMF to ensure that these two conditions have been met is its “conditionality,” which requires that the member be implementing an appropriate economic adjustment program.<sup>77</sup> The adoption of corrective economic policies is designed to provide some assurance that the underlying problem will be resolved but also that, because of this favorable outcome, the country will have adequate foreign exchange to repay the IMF.

The current debate on IMF financial assistance in this area arises in large part from the unprecedented scale of IMF financing packages that have been provided during the last nine years. Under the IMF’s current access policy, which provides guidance as to the amount that the IMF will normally provide to its members in support of their economic reform programs, the annual limit is set at 100 percent of quota. While this policy authorizes the IMF to exceed this limit in exceptional circumstances, prior to Mexico’s financial crisis in 1994, recourse to financing above the normal limits had been rare.<sup>78</sup> The amount provided during the Mexican crisis was the equivalent of 688 percent of quota. Financial support in Asia established new records: when calculated as a percentage of the quota of the member in question, the arrangements approved for Thailand, Indonesia, and Korea were 600 percent, 490 percent, and 1,939 percent, respectively. The scale of recent IMF lending is largely due to the nature of the problems that precipitated the crises in question. While the ability of many emerging market countries to access the global capital markets has brought many benefits, the risks have also become painfully clear. A buildup in the stock of debt—particularly short-term debt—through such borrowing creates the potential for massive capital outflows, where changes in market perceptions make investors unwilling to roll over their debt. Whether the borrowing is conducted by the banking

sector, the enterprise sector, or the sovereign itself, perceptions regarding overindebtedness can also precipitate capital flight by the country's own residents. The potential for volatility is exacerbated by the herd mentality of the market: creditors often ignore signs of economic vulnerability for too long, but, when they do become aware of them, they can overreact. In these circumstances, the objectives of IMF financing have been to catalyze a return of market confidence in the country; to wit, by providing a large amount of financing in support of a strong economic adjustment program, the aim is to slow and stop capital outflows and initiate the transition back to access to private capital markets. One of the features of this strategy—often referred to as the “catalytic” approach—is that it seeks to resolve the member's balance of payments problem without having to restructure the sovereign's own debt obligations.<sup>79</sup>

One of the perceived weaknesses of the existing crisis-resolution framework is that there is inadequate predictability as to how much financing the IMF would be willing to commit in support of the catalytic approach described above. In the absence of clarity in this area, it has been argued that both the debtors and creditors delay discussions regarding the need for restructuring in the hope that such a painful event may be avoided through additional financing from the IMF.<sup>80</sup> While, in some cases, the financing package has been successful and a restructuring of sovereign debt has been avoided (e.g., Mexico in 1994 and Brazil in 2001), in other cases the program did not succeed in sparing the country and its creditors from default (e.g., Russia in 1998 and Argentina in 2001). It may be argued that the financing provided by the IMF in the latter set of cases merely delayed a restructuring that had become unavoidable, and that these delays merely increased the cost of restructuring for all concerned.

A related—but far more fundamental—criticism of IMF financing policy is that it engenders what is generally referred to as “creditor moral hazard.”<sup>81</sup> Specifically, even where the financing provided by the IMF under the catalytic approach actually succeeds in avoiding a restructuring of sovereign debt, it is perceived by some as having the negative effect of shielding creditors from the risks they incurred and were paid for when they extended credit to the emerging market country in question. From a systemic perspective, the concern—which has been expressed both by academics and some within the official sector—is that protecting creditors from these

losses only encourages further reckless lending, and as a consequence, engenders further instability in the international financial system. In sum, while the absence of predictability in IMF financing policy is perceived as raising the cost of resolving crises, concerns have been expressed that the moral hazard created by such financing may actually increase the likelihood that these crises will occur in the first place.<sup>82</sup>

How valid are these criticisms? Regarding moral hazard, it may be said that—at some level—this will always be an unavoidable outcome of IMF financing. As noted earlier, the purpose of IMF financing is to “shorten the duration and limit the degree” of disequilibrium in the international balance of payments of members. If this objective is achieved and the financial costs of crises are contained, the country and its creditors are likely to be more relaxed about the risk of a crisis than they would have been if IMF financing had not been forthcoming. However, perhaps a more relevant question is whether there is evidence that the additional moral hazard created by the significant financing packages from the IMF is so large that it outweighs the benefits of IMF financing for these countries and for the international financial system more generally. Is the problem of moral hazard so great that it would have been better to withhold financing to Mexico in 1995 or Brazil in 1999 and 2002, notwithstanding the economic and financial costs that an ensuing restructuring would have created both for these countries and for other IMF members?

Even those that express great concern over the increased scale of IMF financing concede that there is little empirical evidence to suggest that such financing has engendered reckless lending by private creditors.<sup>83</sup> Moreover, notwithstanding the IMF’s large financing packages, investors now understand that there will indeed be circumstances where emerging market economies may have no choice but to restructure their claims. The defaults of Russia, Ukraine, Ecuador, and Argentina have sent a particularly powerful signal in this regard. Even in those countries where there has been no sovereign default or where the crisis has been avoided without resort to exchange controls, it would be wrong to assume that investors have been shielded from losses. In particular, while the IMF provided an unprecedented amount of financing during the Asian financial crisis,

investors holding equity or long-term debt issued by corporations and financial institutions were forced to incur significant losses.

The criticism regarding the unpredictability of the IMF's access decisions raises difficult issues. On the one hand, the development of clearly defined hard limits on the amount of financing provided by the IMF would help shape expectations of both the countries and their creditors; this would ideally result in unavoidable restructurings taking place earlier rather than later, a benefit to all. At the same time, however, this predictability would come at a cost. Specifically, the imposition of absolute, quantitative limits (expressed as a percentage of a member's quota in the IMF) would preclude the IMF from providing financing above those limits in circumstances in which large amounts of financing, coupled with strong economic policies, would catalyze a return of market confidence and, thereby, avoid a costly restructuring.

This does not mean that there should be no limits on IMF financing; rather, it suggests that any limits need to be designed in a manner that gives due regard to the overall objectives of such financing. Most importantly in that regard, the IMF should not provide additional financing once it has formed the judgment that the member's debt is unsustainable, unless the member commits to a restructuring process. When a member's debt is unsustainable, providing IMF support without restructuring the sovereign's debt would run counter to the IMF's mandate; in other words, the financing would simply delay the resolution of a member's external problems, and such delays would most likely exacerbate the crisis when it arises. Moreover, given the overindebtedness of the country, there would be a significant risk that the IMF would not be repaid.

Another consideration that will need to shape the design of IMF access policy is the fact that its resources are finite. The continued provision of large financing packages to certain members runs the risk of undermining the IMF's ability to provide financing to others.<sup>84</sup> Moreover, the absence of portfolio diversification creates its own financial risks: a large concentration of IMF exposure in several countries would create significant financial problems in the event that the catalytic approach is unsuccessful and the ensuing financial crisis results in the country defaulting on the IMF loan.

While the above considerations provide an appropriate basis for the design of an IMF access policy, the implementation of such a policy has proven difficult. Most importantly, even where the IMF has determined that a member's debt is most likely unsustainable, it has come under considerable pressure to continue to provide financing, the hope being that a little more financing, when coupled with further adjustment, may restore market confidence and avoid a painful restructuring. Not surprisingly, the intensity of the pressure arises, at least in part, from the uncertainty of the restructuring process. As stated by Stanley Fischer, shortly after he stepped down from the position of First Deputy Managing Director of the IMF in August 2001, this uncertainty "distorts the behavior of the international system":

Nonetheless, the absence of procedures for dealing with situations where debts have a very high probability of becoming unsustainable distorts the behavior of the international system. Under present circumstances, when a country's debt burden is unsustainable, the international community—operating through the IMF—faces the choice of lending to it or forcing it into a potentially extremely costly restructuring, whose outcome is unknown. I believe the official sector should go very far to help countries that are willing to take the necessary measures to avoid debt defaults, but debts will sometimes have to be written down. That should be costly for the country concerned, but not as costly as it is now.<sup>85</sup>

### **Policies, Process, and Equity**

Let us assume that a sovereign can be given adequate incentives to restructure unsustainable debt earlier rather than later and that effective mechanisms can be established to resolve collective action problems. Even under these conditions, the restructuring process will be excessively painful for all if, once the crisis arises, the debtor fails to adopt appropriate policies. These policies may be described as falling into two categories.

The first category embraces a broad range of substantive economic policies. Unless the sovereign is willing and able to formulate and implement appropriate economic policies that have a

credible chance of achieving balance of payments viability, there will be no predictability regarding the medium-term prospects of the country and, more specifically, no clarity as to the country's payments capacity. In these circumstances, creditors are likely to prefer retaining the "option" value associated with their original claim and will understandably eschew entering into a new agreement that the debtor may not be able to honor.

The second category includes policies that define the process by which the restructuring will actually take place. The general perception among many market participants is that sovereign debtors often fail to engage in a constructive dialogue with creditors regarding the possible terms of a restructuring, favoring instead take-it-or-leave-it exchange offers in circumstances in which creditors do not have sufficient information to make informed decisions.<sup>86</sup> Such an approach creates a suspicion among market participants that debtors may deliberately be taking actions to generate uncertainty in the restructuring process (through intermittent delays in moving forward in an exchange offer or public statements) so as to drive down the price of their claims on the secondary market, thereby creating substantial room for an exchange offer that will give substantial gains.<sup>87</sup> In any event, the unwillingness to negotiate with creditors in an organized framework and, in certain circumstances, the failure to provide adequate information have had the effect of ensuring that it is the debtor rather than the creditor who maintains the initiative during the restructuring process.

While the above strategy may help the debtor obtain more favorable restructuring terms and may also be of benefit to the distressed debt purchasers—who, having bought at a steep discount, are able to reap a considerable profit in the exchange—investors who extended the credit in the first place or purchased the debt at or near face value clearly have much to lose from this strategy. Managers of emerging market funds that attempt to attract this latter type of investor have noted that the absence of a fair restructuring process will make it more difficult to attract such "buy-side" investors, with the effect that there will be a decline in capital flows to emerging market economies.<sup>88</sup> Of course, one must carefully evaluate statements made by the private sector suggesting that future capital flows will dry up absent adequate reform. In this era of globalized financial markets, investment banks compete to seek new mandates

and fund managers find it difficult to turn away the potential profits that can be generated by lending to an emerging market country at a significant risk premium.

The IMF has been criticized for not using its leverage over debtors more forcefully to support a more collaborative restructuring process. Under its “lending into arrears” policy, the IMF is authorized to provide financing to a member that is in arrears to its private creditors. Originally established in 1989, the policy enables the IMF to provide balance of payments support to countries that are implementing a strong economic adjustment program but have not yet reached a restructuring agreement with their private creditors. The policy effectively precludes private creditors from exercising a de facto veto over IMF financing. However, as a condition for providing financing under the policy, the IMF must make a determination that the member country is making a “good-faith effort to reach a collaborative agreement with its creditors.”<sup>89</sup> The requirement that there be some progress in the normalization of the member’s relations with its creditors is derived from the fact that, for these countries, their ability to re-access capital markets in the medium term is judged to be a critical element of medium-term viability. Moreover, such re-access will also provide an important means by which the member will repay the IMF. When the policy was applied in the context of the restructuring of Ecuador’s external debt in 1999–2000, the IMF was criticized by creditors for applying this requirement too liberally when it continued to provide financing even though—at least in the views of Ecuador’s creditors—Ecuador’s restructuring strategy was not a collaborative one.<sup>90</sup>

The ire of the market has also been directed at official bilateral creditors, whose claims on sovereign debtors are restructured under the auspices of the Paris Club. The practices that have been developed by the Paris Club regarding the restructuring of bilateral debt have evolved over time.<sup>91</sup> As a general rule, though, Paris Club restructurings consist of the rescheduling of principal and the deferral of interest payments (“flow restructuring”) rather than the reduction in the stock of debt. Decisions by the Paris Club to restructure are normally taken in conjunction with the approval of an IMF financing arrangement. On the one hand, an IMF arrangement provides the Paris Club creditors with the signal that the members are conducting appropriate adjustment policies. On the other hand, a Paris Club



restructuring allows for the resumption of export credit cover that is often critical to the implementation of the IMF-supported economic program.

Complaints made by private creditors regarding the Paris Club are twofold. The first relates to process. The Paris Club creditors generally reach agreement on the terms of a restructuring earlier than private creditors, reflecting, in part, the delays that arise as a result of private sector debt being held by a diffuse group of creditors rather than a handful of banks. Private creditors thus complain that the Paris Club establishes the minimum terms of the private sector's restructuring through the application of the Club's "comparability of treatment" provision, yet the private sector does not have the opportunity to provide input into the process. This provision commits debtors to seek "comparable treatment" from other creditors, with the Club creditors retaining discretion in the assessment of comparability. The second complaint relates to the terms themselves. While sovereign debtors have often sought significant debt and debt-service reduction from their private creditors, the Paris Club has often been willing to reschedule only maturities falling due within a specified period, thereby requiring repeated reschedulings.

The above complaints against the Paris Club need to be seen in perspective. The cases where a sovereign debtor has significant exposure to both the private sector and the official bilateral creditors are relatively rare. Not surprisingly, the claims of official bilateral creditors normally constitute a significant portion of debt for those countries that have not yet been able to access private capital. Moreover, it is not entirely clear whether official bilateral creditors do, in fact, receive preferential treatment. Paris Club creditors typically reschedule over extended periods at interest rates linked to their cost of funds. When calculated on a net present value basis (i.e., when discounted at the secondary market yield on the debtor's other liabilities), these reschedulings may imply a significant reduction in the net present value of the claims. Moreover, debtors have run arrears to official creditors for extended periods while remaining current on their debt to private creditors.

Notwithstanding these considerations, however, there is an emerging consensus that the overall restructuring process could be improved through greater coordination between official and bilateral

creditors. Even if the differentiated treatment between these creditors is justified, greater coordination, information exchange, and overall dialogue would go a long way toward deflating suspicions regarding inter-creditor equity.

## The Design of the SDRM

### Overview

The IMF launched the SDRM proposal in November 2001, and its design evolved considerably over the subsequent 18 months. A review of the features of the SDRM proposal that were endorsed by most of the IMF's Executive Directors in April 2003 (Proposed Features)<sup>92</sup>—the text of which appears in Appendix III—reveals a framework that seeks to address many of the perceived weaknesses identified in the previous section. An underlying assumption behind the Proposed Features is that, because there is an important relationship among these weaknesses, reform in one area would also facilitate progress in another.<sup>93</sup>

Improving collective action among creditors is clearly an area of primary focus under the SDRM proposal. As a means of addressing the problem of holdout creditors, the Proposed Features envisage a legal framework that would enable a qualified majority of creditors to make critical decisions, including—but not limited to—the acceptance of the final restructuring terms, that would be binding on all private creditors holding external claims.<sup>94</sup> While this decision-making process is similar to that utilized in collective action clauses, the SDRM outlined in the Proposed Features is more ambitious—and intrusive—than collective action clauses in several important respects. First, consistent with the approach followed in domestic corporate rehabilitation laws, the SDRM would “aggregate” claims across different instruments—irrespective of whether there is a contractual voting framework that links these instruments.<sup>95</sup> More specifically, the qualified majority needed to make decisions—and the overall creditor body being bound by such a decision—would be calculated on the basis of all of the creditors affected by the restructuring.<sup>96</sup> The Dispute Resolution Forum, a centralized body, would be given exclusive jurisdiction over all disputes that may arise during the restructuring proceeding. Second, the voting provisions of the Proposed Features would be applied to the stock of claims in

existence at the time of its establishment. Finally, the Proposed Features would bind not only contractual claims but also judgment creditors.<sup>97</sup>

Another objective of the SDRM proposal is to catalyze a more predictable, equitable, and collaborative debt restructuring “process”—in terms of both debtor engagement with creditors and interaction among creditors. Several elements of the Proposed Features are of particular relevance in this regard. First, the sovereign debtor would be required to provide comprehensive information to creditors at an early stage in the process.<sup>98</sup> Second, the fact that claims are aggregated across instruments for voting purposes would, in and of itself, foster greater inter-creditor dialogue and coordination. To the extent that such coordination resulted in the creation of an identifiable and credible creditor counterpart from an otherwise atomized group of creditors, it would also increase the likelihood that the sovereign debtor would engage in a meaningful dialogue earlier rather than later in the process. In that regard, a representative creditors’ committee under the Proposed Features is envisaged as playing an important role in resolving both debtor-creditor and inter-creditor issues.<sup>99</sup> Finally, the possible inclusion of official bilateral creditors under the SDRM proposal, albeit as a separate class, is designed to facilitate the resolution of the type of inter-creditor equity issues that have become the matter of increasing focus over the past several years.<sup>100</sup>

The relationship between the SDRM proposal and IMF financing is a nuanced one. The Proposed Features do not envisage mandatory quantitative limits on IMF financing.<sup>101</sup> Despite the inherent uncertainty that arises when making judgments as to whether a member’s debt is sustainable, the IMF believed—and still believes—that this criterion is preferable to the mechanical application of mandatory limits. Any benefits of predictability that would arise from the use of such limits are still considered to be outweighed by the costs—both for the member and the system more generally—that would flow from the IMF’s inability to provide significant support in circumstances in which there was a good likelihood that such financing would facilitate a return to viability without a restructuring.

Nevertheless, when the SDRM proposal was developed, it was recognized that it would make it easier for the IMF to resist pressure

to provide financing to a member whose debt is judged to be unsustainable. By establishing a legal framework, sanctioned by the international community, that made the restructuring process more rapid, orderly, and predictable—and therefore less costly—the assumption underlying the SDRM proposal was that it would produce a credible alternative to continued financing, on the one hand, and an uncertain and potentially chaotic restructuring process on the other.<sup>102</sup>

The premise of the SDRM proposal is that the costs of restructuring for both the sovereign and its creditors would be reduced by eliminating unnecessary delays—in terms of both the initiation and the completion of the restructuring process. Fully aware that the SDRM would make the IMF less indulgent in its financing decisions, a sovereign whose debt is becoming increasingly unsustainable would be more willing to initiate the restructuring process earlier rather than later. This incentive to move early would be enhanced by the availability of robust collective action provisions that would give the sovereign greater confidence that its restructuring efforts would be successful. For their part, creditors would be more willing to make decisions rapidly because of the availability of information from the debtor. Moreover, the establishment of a process that addresses inter-creditor equity issues with greater predictability—as a result of both collective action provisions and the possible inclusion of official bilateral claims—would give creditors the comfort that a decision to restructure their claims would not be taken advantage of by others.

If applied in a sufficiently predictable manner, the SDRM could create incentives for creditors and debtors to reach an agreement without actually having to use it. Moreover, it could also facilitate restructurings prior to defaults, thereby protecting asset values for debtors and creditors alike. In this respect, it would operate like the “prepackaged” insolvency proceedings under Chapter 11.<sup>103</sup> Specifically, the very existence of voting provisions of the SDRM would encourage creditors to coordinate earlier rather than later, laying the foundation for negotiations between the debtor and its creditors. Potential holdout creditors would realize that, unless they were sufficiently flexible, the debtor and its creditors could use the mechanism to bind them to the terms of the agreement. If holdouts did continue to resist, the SDRM would be activated at the end of the process for the sole purpose of binding these creditors to the restructuring process.

Finally, in addition to reducing the costs of restructuring for both sovereigns and creditors, the SDRM proposal was seen as providing broader systemic benefits. To the extent that the absence of a fair and collaborative restructuring process does indeed make potential investors less willing to purchase sovereign debt, the above features could enhance emerging market debt as an asset class.<sup>104</sup> In addition, if the features were able to make the restructuring process more rapid, it could also help in limiting the risk of contagion. Finally, and more generally, by increasing the predictability as to the how the process will unfold, creditors would presumably be in a better position to price and manage risk, thereby increasing the overall efficiency of the capital markets.

Despite its ambitions, the SDRM would be no panacea. First, while it would reduce the costs of restructuring, the costs would still be high for the sovereign, particularly where, for example, the banking system holds a large portion of the debt to be restructured. On one level, of course, the fact that costs would remain high is not problematic since it would serve to contain the risk of debtor moral hazard, that is, these costs would limit the likelihood of opportunistic defaults.<sup>105</sup> Perhaps the SDRM proposal's most significant limitation is that its effectiveness would, in the final analysis, depend on the coherence of the sovereign's policies. No matter how effective the collective action mechanism, creditors would not be willing to agree to a restructuring unless and until the sovereign had formulated—and had made a credible commitment to implement—a medium-term macroeconomic framework that would provide adequate assurance that the country would be able to repay the restructured claims.

To the extent that domestic political constraints make it impossible for the sovereign to take such measures, the existence of the SDRM would not resolve this problem. At the same time, however, it is possible that these political constraints may be considerably less severe if the restructuring process is initiated earlier; if early initiation is successful in reducing—at least on the margin—economic dislocation, it may also serve to diminish the associated political and social constraints on economic policymaking.

The establishment of the SDRM would require a considerable exertion of political will by the international community. Since its

provisions would supersede contractual terms, it would require a statutory basis. This would be achieved through an amendment of the IMF's Articles of Agreement, a multilateral treaty that currently has 184 signatories.<sup>106</sup> Under the IMF's Articles, member countries have the obligation to ensure that all steps have been taken under their domestic law to ensure that the provisions of the agreement—and any amendments—will be given full force and effect in their territory.<sup>107</sup> Since the amendment establishing the SDRM would interfere with the rights of private persons, the constitutional framework of some countries would require the adoption of domestic legislation. Not surprisingly, even as considerable progress was being made with respect to the design of the SDRM proposal, doubts continued to be expressed as to its political feasibility.<sup>108</sup>

### **General Design Issues**

As discussions regarding the SDRM proposal advanced, it became increasingly clear that the design of its specific features was being guided by a number of general considerations, or “meta-design” issues.

#### ***The Corporate Rehabilitation Analogy***

During the development of the SDRM proposal, nongovernmental organizations, legal and economic academics, and market participants contributed their own views as to whether a new legal framework was needed and, if so, how it should be structured. In that context, a number of commentators expressed the belief that the objectives and features of domestic insolvency legislation—particularly corporate rehabilitation legislation—provided important guidance when contemplating both the utility and design of the SDRM proposal.<sup>109</sup> Indeed, even before the SDRM proposal was launched in November 2001, a number of important contributions had been written regarding the potential relevance of domestic statutory rehabilitation frameworks to the resolution of financial crises.<sup>110</sup>

At a certain level of abstraction, there is little question that corporate rehabilitation laws are of relevance when considering both the desirability and design of a statutory sovereign debt restructuring framework. As with the SDRM proposal, corporate rehabilitation laws are based on the assumption that collective action problems

among creditors are a sufficiently important form of market failure to require intervention from the official sector in the form of a statutory framework.

Nevertheless, as the details of the SDRM proposal developed, it became increasingly clear that there are important limits to the corporate rehabilitation analogy. Corporate rehabilitation laws operate within the context of a broader set of rules that provide for the enforcement of creditor rights against the defaulting debtor.<sup>111</sup> Perhaps most importantly, they function within the shadow of corporate liquidation; where a rehabilitation plan fails to muster adequate support from the creditor community, the company will normally be liquidated in accordance with the provisions of the liquidation law—an outcome that is not applicable in the sovereign context.<sup>112</sup> While the existence of a liquidation law has an important disciplining effect on the debtor, it also provides an important benchmark for resolving inter-creditor problems when the terms of a restructuring plan are developed. For example, emerging best practices in this area require that, under a rehabilitation plan, a dissenting creditor may not receive less than what it would have received under liquidation, taking into consideration the creditor's ranking under the liquidation priority rules.<sup>113</sup> Given the unique qualities of attributes of a sovereign state, there are other aspects of corporate rehabilitation laws that could not be applied. For example, consistent with the objective of maximizing the value of creditors' claims, many modern rehabilitation laws allow for the creditors to commence rehabilitation proceedings unilaterally and to acquire the company through a reorganization plan that includes debt-for-equity conversion. Moreover, rehabilitation laws also place legal constraints—to varying degrees—on the company's activities during the proceedings. The ability to establish and enforce such limits against a sovereign state would clearly be problematic.<sup>114</sup>

For critics of the SDRM proposal, these differences serve to underline the difficulty of establishing a statutory framework to restructure the debt of a sovereign. In particular, the absence of an equivalent enforcement mechanism against a sovereign that would balance the protection provided to it under a statutory framework may be particularly problematic.<sup>115</sup> More generally, would not the adoption of such a framework in the sovereign context create a problem of “debtor moral hazard”?

While such concerns are legitimate, the perspective of the IMF has been that the SDRM could nevertheless be designed to address the distinguishing features of a sovereign state and that a number of features of domestic insolvency laws (particularly those that relate to voting and the aggregation of creditor claims) may provide useful guidance in the sovereign context. To minimize the risk of debtor moral hazard and, more generally, any disruption in the operation of capital markets, the Proposed Features are designed so that they do not shift legal leverage from creditors to the debtor.<sup>116</sup> Rather, the majority voting provisions of the SDRM proposal serve to increase the leverage of creditors as a group over individual creditors. Thus, for example, any stay on enforcement pending a restructuring agreement could only be established with the requisite creditor support.<sup>117</sup>

### ***The Role of the IMF***

One of the most difficult issues that arose during the discussion of the SDRM proposal was the role of the IMF in its establishment and operation. On the one hand, there are several advantages to establishing a statutory sovereign debt restructuring framework through an amendment of the IMF's Articles of Agreement. First, by virtue of the amendment provisions of the IMF's Articles, it provides a basis for establishing a universal framework (184 countries are currently signatories) without the need for unanimity. Under the terms of the Articles, an amendment approved by three-fifths of the IMF's members holding 85 percent of the IMF's total voting power will become binding on all members.<sup>118</sup> Second, by relying on the IMF's Articles, there is some assurance that the framework, once established, would remain universal. A country wishing to withdraw from the SDRM would need to bear in mind that it could only do so by depriving itself of the benefits of membership in the IMF, including the benefit of financial assistance. Replicating a similar incentive structure in a new stand-alone treaty would be difficult. Finally, given the mandate of the IMF in providing assistance to countries that are resolving their financial crises, it is inevitable that the IMF's decisions would affect the operation of the SDRM, particularly with respect to judgments as to the sustainability of a member's indebtedness.



At the same time, however, active participation by the IMF in the operation of the SDRM raises a number of difficult issues. First, there is the problem of a potential conflict of interest. As in the case of a domestic insolvency law, the operation of the SDRM will require the existence of an independent institutional infrastructure that will be able to resolve disputes that may arise between the debtor and its creditor and among creditors. It is clear that the IMF's Executive Board could not play this role. Not only is the IMF a creditor, but the IMF's Executive Directors also reflect the interests of IMF members, that is, national governments, some of which will also be creditors.<sup>119</sup> Second, and perhaps even more important, concerns were voiced that, because of this governance structure, political considerations could also play a role in the Executive Board's decisions.<sup>120</sup> Finally, there was a fear of "mission creep"; for an institution that is already perceived by many as being excessively powerful, concerns have been expressed about any reform that would give it any further authority.

As the design of the SDRM proposal evolved, the IMF attempted to address these concerns by effectively eliminating any formal role of the Executive Board in the process. In effect, all decisions would be made by the debtor and a qualified majority of its creditors. The Articles of Agreement would merely provide the legal basis for making these decisions binding on the rest of the creditor body. With respect to the resolution of disputes, the amendment would establish a dispute resolution forum that would be independent of the Executive Board and all other organs of the IMF. As discussed below, certain features relied upon in other treaties would be used to ensure that this organ would operate—and would be perceived as operating—free of any influence of the IMF's Executive Board.<sup>121</sup>

Of course, the IMF would still exercise considerable influence over the process through the exercise of its traditional financial powers. Perhaps most important, in circumstances in which it discontinues financing because of a determination that the member's debt is unsustainable, this would probably leave a country with little choice but to initiate the SDRM. Moreover, the IMF would also play an important role at the end of the process, that is, when the sovereign's creditors are asked to accept a restructuring offer. At that stage, it is very likely that an IMF-supported program would need to be in place to provide some assurance to creditors that the sovereign

is implementing policies that will give it the capacity to service the restructured claims. In sum, while the SDRM would not give the IMF's Executive Board any additional legal powers, its operation would rely on the exercise of the IMF's existing financial powers.

### ***The Benefits of Minimalism***

The substantive and procedural rules of most modern domestic insolvency laws tend to be relatively detailed. Indeed, to the extent that such laws can anticipate and resolve most of the issues that can be expected to arise in their application, they are likely to enhance the overall predictability of the credit system. However, the establishment of detailed treaty obligations that provide guidance on all aspects of the restructuring process was not the approach followed by the IMF when developing the SDRM proposal. Rather, the Proposed Features provide for a relatively simple and streamlined framework that is designed to create incentives for early and expedited negotiations between the debtor and its creditors—not a fully elaborated blueprint for a restructuring. This approach was motivated in large part by a concern that, given the inevitable evolution of the capital markets, overly narrow and detailed rules would become outdated or subject to circumvention. While, in the domestic insolvency context, such risks can be addressed through periodic changes to the relevant law, this is more difficult to achieve where the legal instrument in question is an international treaty with 184 signatories. In addition, there was a concern that a complex mechanism with a number of moving parts would have unanticipated—and unwanted—consequences on the international financial system. As noted in the Proposed Features, while the SDRM would interfere with contractual relations, the objective is to limit such interference to the resolution of only the most important collective action problems and, as indicated earlier, to resolve them in a manner that does not create debtor moral hazard.<sup>122</sup>

The need to fashion a relatively minimalist framework was also dictated by the immovable reality of state sovereignty. Debtors are unlikely to accept the involuntary commencement of the SDRM, the establishment of onerous legal obligations, or, more generally, any significant interference with the exercise of their sovereign powers. In their final form, the Proposed Features can be described as establishing a legal instrument available to sovereigns to restructure their claims if they are of the view that it would be in their interest to

do so. If a sovereign were to use the SDRM in a manner that was inconsistent with its terms, provisions of the Proposed Features would preclude the sovereign from enjoying its benefits. Such actions by the sovereign would not, however, constitute a violation of international obligations.

Concerns regarding interference with state sovereignty were not limited to potential debtors. For example, member countries whose citizens were likely to be private creditors under the mechanism were concerned about the establishment of a supranational entity that would exercise exclusive jurisdiction over the resolution of disputes involving these creditors and whose decisions would be binding on domestic courts. This was a key reason why the powers of the proposed Dispute Resolution Forum (DRF) are significantly circumscribed under the Proposed Features.<sup>123</sup>

## **Specific Design Issues**

### ***The Scope of Debt***

When the debt burden of the sovereign is judged to be unsustainable, it is very likely that the scope of debt that requires restructuring will have to be comprehensive in order to achieve a reduction in the debt and debt-service burden of sufficient magnitude to restore sustainability. A comprehensive debt restructuring may also be required to address inter-creditor equity concerns; creditors holding one type of claim may only be willing to restructure their debt if other creditors also contribute to the restoration of sustainability.

However, while it is relatively clear that a restructuring of unsustainable sovereign debt may need to include a broad and diverse array of claims, it is less obvious whether it is feasible—or even desirable—for all of these claims to be restructured under the same legal framework. In that context, two broad issues emerged during the development of the SDRM proposal. First, the question arose whether all claims on the sovereign should be made subject to restructuring under the SDRM or should the scope of such claims be limited to sovereign claims held by private external creditors, where problems of collective action are most severe. Second, to what extent should debt owed by entities other than the sovereign (e.g., public and

private companies and financial institutions) also be restructured under the SDRM in circumstances in which such a restructuring is a necessary condition for the resolution of the financial crisis faced by the sovereign?

With respect to the first issue—the scope of claims on the sovereign that should be restructured under the SDRM—it became increasingly clear during the relevant discussions that the broader the coverage of the SDRM, the more complex the framework would become. To the extent that the SDRM covered very different types of claims—secured and unsecured claims, domestic and external claims, and claims held by both private and official creditors—there would need to be important qualifications to the general principle that voting should take place on an aggregated basis. Otherwise, there would be a risk that a minority of creditors holding a particular type of claim would be unfairly treated by a majority of creditors holding very different claims.

In the context of some nonsovereign rehabilitation laws, the risk of inter-creditor discrimination that arises when aggregating “apples and oranges” is addressed through a classification system.<sup>124</sup> Claims with different priorities under the liquidation law are placed in different classes for voting purposes. Support by the specified majority of creditors in each class would be required to approve the restructuring terms offered to all classes. While votes are aggregated across instruments—thereby reducing the leverage of holdouts within a class—there is no aggregation of votes across classes. However, if all classes were required to approve the overall restructuring, each creditor class would have effective veto power over the terms offered to other classes.<sup>125</sup> Finally, while all creditors within the same class would need to receive the same restructuring terms (or menu of terms), treatment of creditors across classes could be different.<sup>126</sup>

Of course, one of the difficulties of introducing the above framework in the sovereign context is the fact that there is no liquidation law that provides a benchmark for classification. More generally, as has been pointed out recently by a number of observers, there is no clear priority structure for sovereign debt.<sup>127</sup> Finally, there was a concern that the creation of multiple classes could make both the design and operation of the framework excessively complicated. As has been recognized in the nonsovereign context, such complexity

would require greater reliance on the institutions charged to implement it—a reliance that would be particularly problematic given concerns about the creation of a supranational institution and the implications for state sovereignty.<sup>128</sup>

As discussed below, the approach eventually proposed for the SDRM took into account both the above considerations and the nature of the claims in question.

### *Domestic Debt*

Corporate insolvency laws generally do not distinguish between domestic and external debt.<sup>129</sup> Whether that debt is held by a resident or nonresident, or whether it is denominated in local currency or foreign currency, these factors have no legal significance. With the integration of capital markets, there are a number of reasons why a similar approach could be taken in the sovereign context. In an environment in which residents and nonresidents purchase the same types of instruments and trade with each other, creating a distinction based on residency would appear somewhat artificial. Similarly, making a distinction on the basis of the currency of payment or denomination is also not meaningful, at least from a balance of payments perspective. As long as the country does not maintain capital controls, a creditor that receives a payment in the domestic currency will be free to convert this payment into foreign currency and transfer it abroad.

Still, a closer analysis of the unique features of sovereign debt reveals that there are other distinctions between domestic and external debt that may be more meaningful from a restructuring perspective—at least in terms of resolving collective action and inter-creditor equity issues. Perhaps the most important is the legal nature of the claim. Specifically, if a creditor holds a claim that is both governed by the domestic law of the sovereign and subject to the jurisdiction of the domestic courts, its enforcement rights against the sovereign are somewhat limited: even if a creditor is able to obtain judgment in a court located within the territory of the sovereign, it is unlikely that a domestic court will authorize the attachment of assets of the government and central bank.<sup>130</sup> In this respect, claims that are governed by foreign law or subject to the jurisdiction of the foreign courts may be viewed as more “senior” than domestic debt by virtue

of the opportunities for both judgment and attachment that are provided under the foreign sovereign immunity laws of a number of countries.<sup>131</sup>

In light of these considerations, the IMF considered two different approaches with respect to the SDRM proposal's coverage of domestic debt. Under the first, domestic debt (i.e., claims governed by domestic law and subject to the jurisdiction of the domestic courts) would be included under the SDRM, but as a separate class from external claims (i.e., claims governed by a foreign law or subject to the jurisdiction of a foreign court).<sup>132</sup> Consistent with the approach followed in the nonsovereign insolvency context, an affirmative vote by a qualified majority of each class would be necessary for the overall restructuring to go forward, thereby giving holders of domestic claims and external claims a reciprocal veto over each other. In circumstances in which the majority of the claims are domestic, this approach would prevent holders of these claims from imposing restructuring terms upon a minority of creditors holding external claims—including terms that would involve stripping the superior enforcement rights from the minority.

Under the second approach, domestic debt (similarly defined) would be restructured outside, but parallel to, the SDRM. Where a restructuring of both domestic and external debt was judged necessary, creditors holding external claims would be able to take account of the terms being offered to domestic creditors outside the SDRM before voting on a restructuring agreement under the SDRM. If the terms offered to domestic creditors did not, in the view of external creditors, provide for adequate inter-creditor equity, external creditors would refuse to agree to a restructuring of their own claims. The transparency requirements of the SDRM, discussed below,<sup>133</sup> would ensure that external creditors would have all relevant information regarding the treatment of domestic debt when they made this decision.

The second approach prevailed for a number of reasons. First, in terms of resolving collective action problems, the inclusion of domestic debt under the SDRM proposal was not considered necessary given the relative weakness of enforcement rights against the sovereign. Because of these perceived weaknesses, holdout creditors holding these claims would not have enough legal leverage

to disrupt the restructuring process.<sup>134</sup> Of course, there is always the risk that a holder of a domestic claim could take measures to enhance its enforcement rights. Specifically, if it is able to obtain a judgment but unable to enforce its claim in the courts of the sovereign debtor, it may attempt to enforce the judgment abroad pursuant to bilateral or multilateral treaties that provide for the recognition and enforcement of judgments. To address such a risk, the Proposed Features provide that a domestic claim would become an external claim (and therefore subject to the SDRM) once it is recognized and enforced outside the territory of the sovereign debtor.<sup>135</sup>

The second reason for excluding domestic debt from the coverage of the SDRM relates to inter-creditor equity. During the development of the SDRM proposal, considerable uneasiness was expressed by external creditors with any framework that would give domestic creditors—who possess inferior enforcement rights—an effective veto as to whether the restructuring of external debt could go forward. In contrast, while the second option gave external creditors the option of holding up their own restructuring if they felt the terms offered to domestic creditors were excessively generous, it did not preclude them from concluding a deal with the sovereign in circumstances in which the sovereign had not concluded an agreement with its domestic creditors.

Finally, including domestic claims under the SDRM—even as a separate class—was ultimately viewed as being excessively intrusive from the perspective of national sovereignty. A number of countries could not accept the possibility that debt issued within their own territories and subject to their own laws could be restructured under a legal framework that would be administered by an international dispute resolution body. Even among mature market countries—who were very unlikely to avail themselves of the SDRM to restructure their debt—there was likely to be a concern that the domestic legislature would be unwilling to adopt the SDRM if there was even the remotest possibility that it could be used to restructure domestic debt. The advantage of the second option was that, as long as a sovereign only issued debt governed by its own law and subject to its own jurisdiction, the SDRM could never be used to restructure its own debt.<sup>136</sup>

*Official Bilateral Creditors*

The proposed treatment of sovereign debt to official bilateral creditors under the SDRM received considerable attention both from the official and private sectors and is one of the few important substantive issues that remained unresolved when the Proposed Features were submitted to the IMF's International Monetary and Financial Committee in April 2003. In one sense, it may be argued that the extension of the SDRM to official bilateral claims is unnecessary. As a general matter, the restructuring of official bilateral claims has not been hampered by problems of collective action. The nonbinding decisions of the Paris Club to provide debt relief are normally reached by consensus and are then given effect by individual official creditors pursuant to bilateral rescheduling agreements.<sup>137</sup> This cohesion reflects the public interest that motivates the restructuring decisions of these creditors.

Rather, the potential benefits of including official bilateral claims under the SDRM relate to the resolution of the type of inter-creditor equity problems that have arisen between the Paris Club and the private sector, which have been described earlier.<sup>138</sup> As with domestic debt, two options were considered. Under the first, official bilateral creditors would be included within the scope of the SDRM, but as a separate class from private creditors. While claims contained in each class would not be aggregated for voting purposes, approval of each class would be necessary for the overall restructuring to move forward. The use of separate classes would enable official bilateral creditors and private creditors to receive different terms, thereby taking into account their different interests. At the same time, the mutual veto would provide incentives for early dialogue between the two groups. The second option would involve restructuring official bilateral claims outside the SDRM, but developing procedures that would provide greater predictability with respect to inter-creditor dialogue. Moreover, as is the case with domestic debt, the transparency requirements imposed by the SDRM would ensure that private creditors obtained all relevant information regarding the treatment of official creditors.

Although the private sector was resistant to the SDRM proposal, it was clear that—if one were established—the private sector would prefer official bilateral claims to be included as a separate class. The



fact that it would give official bilateral claims a veto over the restructuring terms provided to private creditors was not considered problematic since, unlike domestic creditors, official creditors were already perceived as having considerable leverage in this process and arguably a form of de facto seniority. To the extent that the SDRM gave private creditors an effective veto over the terms offered to the Paris Club, this would improve the fairness of the overall process from the perspective of private creditors.

Rather, concerns regarding the inclusion of official bilateral claims came from within the official sector, among them being an unease regarding the possible implications on the speed of the restructuring process.<sup>139</sup> Specifically, if official bilateral claims were treated as a separate class within the SDRM, this would create a presumption that this debt would be restructured at the same time as the debt owed to private creditors. One structural concern regarded the flexibility of the SDRM; specifically, there is a concern that the SDRM must be sufficiently flexible to allow for a sequenced approach, so as to ensure that any delays encountered during negotiations between the sovereign and its private creditors would not prevent official bilateral creditors from restructuring their own claims. A second concern related to sovereignty; namely, official bilateral creditors might not be willing to implement a framework in which a restructuring of their claims could be implemented by a decision of a qualified majority, or in which the restructuring of their own claims could be made contingent upon the reaching of a restructuring agreement between the sovereign and its private creditors. Notwithstanding these concerns, there was sufficient recognition within the official sector of the potential benefits of including official bilateral claims within the SDRM that it was decided to leave this question open in the Proposed Features.<sup>140</sup> In the event that the international community decides to return to the SDRM proposal or some other variation of it, one of the key challenges will be to design it in a manner that addresses these concerns while ensuring adequate dialogue and coordination between official bilateral and private claims.

### *Multilateral Debt*

The treatment of debt owed to international financial institutions, including the IMF and the World Bank, raises a very different set of

issues. The Proposed Features provide that claims owed to international financial institutions would not be eligible for restructuring under the SDRM.<sup>141</sup> Unlike domestic debt, the proposed exclusion of these claims was not intended to suggest that they should be restructured outside the SDRM—but rather that, in keeping with existing practice, they should be exempted from the restructuring process altogether.

The tradition of excluding the IMF from the restructuring process reflects what is generally referred to as the “preferred creditor” status of the IMF. Until recently, it has been a practice accepted by official bilateral creditors, private creditors, and sovereign debtors as being in their own self-interest. By shielding the IMF from the risk of nonpayment and restructuring, the IMF can provide financing when other lenders would be unwilling to do so. Such financing—and the economic policies it supports—provides a framework for medium-term balance of payments viability, thereby enhancing the recovery value for all creditor groups. For a sovereign debtor, remaining current with the IMF and implementing an IMF-supported program enable it to unlock additional financing or debt relief from official or private creditors. Stated generally, the premise has been that the claims of these institutions should be treated preferentially because these institutions, by enhancing economic growth and financial stability, provide a public good that, in the long run, is in the interests of all stakeholders.<sup>142</sup> At a certain level of abstraction, the preference given to the IMF can be compared to the priority that is afforded to creditors who provide new financing after the commencement of corporate reorganization proceedings.<sup>143</sup>

During the discussion of the SDRM proposal, questions were raised by nongovernmental organizations as to whether the IMF’s preferred-creditor status should be retained.<sup>144</sup> In some respects, it is not entirely surprising that the IMF’s preferred-creditor status should be the subject of greater scrutiny. As the amount of financing provided by the IMF has increased over the years in the context of capital account crises, its share of the total debt owed by the country has also increased. When a restructuring becomes necessary and private creditors are asked to accept a significant reduction in the value of their claims, there may indeed be demands that the IMF not be excluded from the restructuring process.

Irrespective of the merits of such arguments, there should be no doubt as to the consequences they suggest, both for sovereigns and for creditors. The elimination of the preferred-creditor status of the IMF and other multilateral institutions would result in a decrease in the volume of financing provided by these institutions and an increase in the price of such financing through the addition of a risk premium to the relevant interest rates. Faced with the risk of being treated like any other creditor, these institutions would have no choice but to begin acting like them. In the case of the IMF, such a development would severely constrain its ability to play a catalytic role in the resolution of financial crises, that is, where significant financial assistance in support of strong adjustment programs engenders a return of market confidence, thereby obviating the need for a painful restructuring. The fact that, to date, private creditors have generally not challenged the IMF's preferred-creditor status likely reflects a recognition on their part that—on balance—preserving this status continues to be in their own self-interest.

### *Secured Claims*

Unlike corporations, sovereigns<sup>145</sup> generally borrow on an unsecured basis.<sup>146</sup> When they do offer security, it is subject to the constraints imposed by the “negative pledge” provisions contained in their existing credit agreements, which limit a debtor's ability to collateralize their assets.<sup>147</sup> When designing the SDRM proposal, consideration was given to treating secured claims in a manner similar to how they are treated under many insolvency laws: to the extent that the law permits a secured claim to be restructured without the creditor's individual consent, the majority voting rules require that a secured creditor vote in a separate class from unsecured creditors.<sup>148</sup> The desire to include secured claims under the SDRM was driven primarily by a concern that their exclusion could distort the structure of sovereign borrowing. Specifically, exclusion could create incentives for sovereigns to rely on collateral—rather than the adoption of sound economic policies—as a means of attracting finance.

As work on the SDRM proposal progressed, however, it was recognized that the inclusion of secured claims would complicate the operation of the mechanism in a number of respects. First, it would necessitate the imposition of some form of automatic stay upon the

SDRM's commencement. Faced with the prospect that the SDRM's majority voting rules could result in a restructuring of its claims without its consent, a secured creditor would invariably foreclose upon its collateral, using, where possible, self-help remedies.<sup>149</sup> Apart from the fact that such a stay would represent a significant interference with contractual relations, it would also require giving the secured creditor some form of protection regarding the value of its collateral during the period of the stay, as is required under many insolvency laws.<sup>150</sup> Second, the classification system would not be entirely straightforward. In particular, differences in the types of collateral may make it difficult to place all secured creditors in the same class.

Given these potential complications, it was decided to exclude secured claims from the coverage of the SDRM and to rely on other instruments to ensure that this exclusion would not distort sovereign lending. Most importantly, by virtue of the existence of negative pledge clauses in all of the loans extended by multilateral development banks, it would be possible for the official sector—through these institutions—to control effectively the amount and type of security that is granted by sovereigns.<sup>151</sup> Of course, secured claims would be excluded from the SDRM only to the extent of the value of the security. In the event that the value of the claim exceeded the value of the collateral, the unsecured portion would be subject to the operation of the mechanism.<sup>152</sup> Accordingly, there would need to be an effective valuation process to determine the value of this deficiency.

### *Nonsovereign Debt*

One of the lessons of the Asian financial crisis of 1997–98 is that such crises can be triggered by overindebtedness in the banking and corporate sectors, particularly where much of this debt is of a short-term nature (e.g., interbank credit).<sup>153</sup> As a result of a sudden loss of confidence among external creditors, a large and sudden depletion of reserves can take place. Even when the crisis originates from a default by the government or the central bank on their own claims, this can lead to capital flight when the domestic banks hold a significant portion of the sovereign's debt. Residents, in anticipation of the insolvency of the banking system, will rush to withdraw their deposits and sometimes transfer the proceeds abroad. As a means of stemming

the outflow of capital in the above circumstances, a country may have little choice but to impose capital controls. Of course, resorting to such measures will have its own costs, including that of contagion. Moreover, controls lose their effectiveness over time, as residents find ways to circumvent their application. Nevertheless, they may be necessary for a temporary period while corrective policy measures take hold. In these circumstances, the scope of controls is likely to be broad and will therefore interrupt the ability of domestic banks and corporations to service their claims, resulting in widespread defaults.

During the development of the SDRM proposal, the above analysis raised the question of whether it should be designed to provide some limited protection to banks and corporations from creditor enforcement actions during the period when capital controls are in place, on the grounds that it is the state—rather than the debtor—who is responsible for the payments interruption. This would have required an amendment of Article VIII, Section 2(b) of the IMF's Articles.<sup>154</sup> The decision was ultimately made, however, not to include such an amendment in the SDRM.

This decision was particularly motivated by two considerations. First, upon close examination, staying creditor enforcement with respect to arrears arising from exchange controls would complicate both the design and implementation of the framework. For example, would it be feasible to distinguish between those debtors who, but for the exchange controls, would be in a position to repay their debt and other debtors who do not even have the domestic currency to purchase foreign exchange? It would be preferable for the claims of the latter category to be restructured under the terms of the insolvency law. Moreover, during the period of the stay, mechanisms would need to be established to give creditors the assurances that the owners of the enterprise were not stripping its assets.<sup>155</sup>

The second motivation behind the decision to exclude exchange controls from the SDRM proposal relates to the role of the IMF. As noted above, there was a strong desire to limit the role of the IMF in the operation of the SDRM. To the extent that the SDRM only applies to sovereign debt, this can be easily achieved, given that all decisions are made by the sovereign and a qualified majority of its creditors. However, in the context of exchange controls that give rise to the default of a multitude of debtors (each with its own group of

creditors), such an approach would not be feasible. In these circumstances, the legal authority to approve a temporary stay would need to be vested with a body that had the expertise to determine whether such an action was justified by the circumstances. While the IMF has this expertise, in the end it was decided that providing the institution with such an enhancement of its legal powers would not be acceptable to the international community.

### **Commencement**

The design of the SDRM proposal evolved considerably on the difficult issue of the “trigger,” the conditions precedent to the activation of the SDRM. Throughout the discussion, however, there was continuity with respect to two broad principles. First, to avoid excessive interference with the exercise of state sovereignty, it was recognized that the mechanism could only be initiated by the sovereign.<sup>156</sup> Second—and consistent with the overall objective of the SDRM proposal—it was always understood that the SDRM should only be activated by a country if its debt was unsustainable. The evolution in the design of the SDRM proposal related to how this latter principle would actually be made operational; namely, should the country’s representation that its debt is unsustainable be subject to challenge, and, if so, by whom?

The initial position of the IMF was that, in order to prevent abuse of the SDRM, there would need to be some independent determination as to whether a country’s debt was truly unsustainable.<sup>157</sup> Given its mandate and expertise in this area, the initial proposal envisaged that this role would be played by the IMF and, in particular, its Executive Board.<sup>158</sup> This approach was not well received for a variety of reasons. As a general matter, there was some reluctance to establish any framework that would further enhance the IMF’s authority. For private creditors, the IMF’s role in activating the SDRM was particularly problematic given the fact that one of the consequences of activation under the original proposal was an automatic stay on enforcement.<sup>159</sup> To market participants, an IMF-imposed stay smacked of excessive official intervention on behalf of recalcitrant debtors. Concerns were also expressed regarding the basis for the IMF Executive Board’s judgments on sustainability. Specifically, would the IMF’s assessment be based exclusively on economic criteria, or would political factors enter into the decision-making process?

As a result of these concerns, the proposal was revised so that approval by the Executive Board would not be a condition for the activation of the mechanism. Accordingly, while the mechanism would require the member to represent that its debt was unsustainable, this representation would not be subject to challenge.<sup>160</sup> There was a recognition that this approach was not without its drawbacks, however. Was there not a risk that the absence of any gatekeeper would create a form of debtor moral hazard? Specifically, even when a country's debt is unsustainable, the existence of an internationally sanctioned restructuring framework that can be activated unilaterally could increase the domestic political pressure on governments to restructure sustainable debt for the sole purpose of liberating additional funds for other purposes.<sup>161</sup> Among other things, such an outcome could severely undermine the availability of external financing for emerging market economies.

This risk was mitigated by two factors. First, in light of the economic costs associated with restructuring—no matter how orderly they proceed—most countries would only initiate the mechanism as a last resort, even if they could do so unilaterally.<sup>162</sup> Indeed, the problem to date has been the fact that the restructurings are too late rather than too early. For this reason, it was considered more likely that most countries would only activate the SDRM once the IMF had determined that the member's debt was unsustainable and that further financing from the IMF would not be available unless the member activated the mechanism. Second, the IMF recognized that the extent to which the absence of an independent check would actually increase the risk of abuse would depend on the extent to which the mechanism, once activated, provided the debtor with greater leverage over its creditors. The other features of the SDRM would not provide such leverage. Most important, and as discussed below, it would not provide for an automatic stay on enforcement. Rather, it would merely set in motion a procedure that would facilitate creditor organization and voting on an aggregated basis.

### **The Stay on Creditor Enforcement**

As originally conceived, the SDRM proposal provided for the automatic imposition of a stay on creditor enforcement following its activation.<sup>163</sup> As discussions progressed, however, consideration was given to a generalized stay that could only be imposed by an

affirmative vote of a qualified majority of creditors that would be affected by the restructuring, at which point it would become binding on all affected creditors.<sup>164</sup> In this respect, such a stay would mimic the majority enforcement provisions of collective action clauses.<sup>165</sup> At a very general level, it may be said that the evolution in the thinking of IMF staff on this question reflected a recognition that, given the overall fragility of creditors' enforcement rights against a sovereign, an automatic stay would constitute an unnecessary and inappropriate shift in legal leverage from creditors to debtors—one which, on the margin, could encourage (or be perceived as encouraging) defaults by debtors.<sup>166</sup> However, as work on other features of the SDRM progressed, more specific reasons emerged as to why, in the sovereign context, an automatic stay would be problematic.

In the corporate rehabilitation context, an automatic stay on creditor enforcement is accompanied by a stay on payments by the debtor to other creditors.<sup>167</sup> Indeed, these two measures, taken together, constitute a “standstill” that is designed not only to protect the business as a going concern but also to ensure inter-creditor equity. A creditor has the assurance that, during the period it is unable to enforce its rights, the debtor will be precluded from dissipating assets by making payments to other creditors. In the sovereign context, however, it would be very difficult to provide for—or enforce—the general cessation of payments that provides the necessary counterpart to the stay on creditor enforcement.

The first difficulty is an economic one. Even when a sovereign's debt is unsustainable, it is very likely that it would wish to exclude certain claims from the restructuring process and continue servicing these claims—whether or not such claims are eligible to be restructured under the SDRM. For example, when the banking system holds a significant portion of the sovereign debt, a default is likely to trigger a run on deposits and, as a consequence, significant capital outflows. To the extent that this results in the insolvency of the banking system, this will have catastrophic consequences not only in the short term (with the resulting collapse of economic activity) but also in the long term, as the cost of recapitalization seriously undermines the country's fiscal position—and, therefore, its ability to service its restructured debt. Notwithstanding inter-creditor equity concerns, a creditor whose debt is being restructured may, therefore, also be of the view that it is to its advantage for the sovereign to



exclude certain claims from the restructuring process. For this reason, as discussed further below, the claims that would be subject to a restructuring would be limited to those identified by the sovereign.<sup>168</sup> To the extent that such creditors—who would receive this information pursuant to the SDRM’s information requirements<sup>169</sup>—were of the view that the scope of the restructuring was unjustifiably narrow from an inter-creditor equity perspective, they would signal that their own support for a restructuring proposal would be contingent on an expansion.

This approach has important implications for the design of any stay on enforcement; in an environment in which it is highly likely that the sovereign will wish to interrupt the payment of certain claims but continue to service others, there are strong reasons why, from an inter-creditor equity perspective, any stay on enforcement should only be put in place following a vote by the creditors affected. Through such a vote, creditors could indicate whether the exclusion of certain creditors is justified, because, for example, such an exclusion was a necessary means of limiting economic dislocation.

Another difficulty with the concept of a general standstill in the sovereign context relates to its lack of enforceability against sovereign debtors. Assuming that a general cessation of payments were considered appropriate from an economic perspective, creditors would not have the assurance that payments by the sovereign would actually be prevented. In the corporate context, creditors have such an assurance, and it provides an important balance to the automatic stay. To that end, a court-appointed representative will often supervise the management of the corporation during this period to ensure that such payments are not being made and that assets are not being dissipated more generally.<sup>170</sup> Under the SDRM proposal, how would creditors be given such an assurance without seriously compromising the principle of sovereignty? In the absence of an enforceable stay on payments by the debtor, a stay on creditor enforcement that requires some form of creditor approval was considered to be more appropriate. Before voting on whether to impose a stay, creditors could assess whether the sovereign debtor was pursuing economic and financial policies—including policies relating to the making of payments—that would enhance the value of their own claims.

Notwithstanding its merits, the creditor-approved stay has its drawbacks. Most important, a framework under which all creditor voting is to take place on an aggregated basis would inevitably include a time lag between the date of commencement and the date when creditors will be in a position to make decisions, including decisions regarding a stay. As discussed below, creditor claims would need to be verified, and, even when conducted on an accelerated basis, this process could take months.<sup>171</sup> During this period, would there be a risk that creditors would enforce their claims and that such enforcement actions could disrupt the restructuring process?

On the one hand, it is clear that the “rush to the courthouse” that provides one of the justifications for an automatic stay under corporate rehabilitation laws does not exist in the sovereign context. While creditor enforcement rights against a sovereign have become increasingly more meaningful over the years, they do not yet benefit from the degree of speed and predictability that exists in the corporate context, particularly with respect to unsecured claims.<sup>172</sup> On the other hand, there was a recognition that the SDRM—under an international treaty that could not be easily amended on a periodic basis—had to be designed so that it could accommodate an evolution in the legal environment, the direction of which could be affected by the SDRM itself. For example, while most litigation to date has taken place after a restructuring agreement has been reached, the majority voting provisions of the SDRM could change that dynamic; faced with the fact that any restructuring agreement could be made binding upon them without their consent, distressed debt purchasers could conclude that they had no choice but to enforce their claims before such an agreement was reached.

In light of the above, considerable attention was devoted within the IMF to designing measures that would supplement a creditor-approved stay, but which could be controlled by creditors (as a group) rather than by the debtor. In some respects, the scope of the problem was limited by the fact that the claims to be restructured under the SDRM would include judgments arising from external contractual claims.<sup>173</sup> Accordingly, a litigating creditor could avoid being subject to the SDRM only if it were able to obtain a judgment and satisfy the judgment prior to the sovereign reaching a restructuring agreement with its creditors. Given the expense of

litigation, this uncertainty would pose an important deterrent to litigation.<sup>174</sup>

In addition, two other measures were included in the Proposed Features for purposes of counteracting emerging litigation strategies that may evolve. The first was based on the “hotchpot” rule that was developed in nineteenth-century English bankruptcy law.<sup>175</sup> Under the proposed rule, a judgment creditor that had managed partially to satisfy its claim through a collection prior to an SDRM restructuring agreement would have the value of its residual claim under the agreement reduced in a manner that ensures that all of the benefits of enforcement are neutralized—but with the added disadvantage of legal expenses.<sup>176</sup> Consistent with the overall objective of not tilting the balance of leverage in favor of the debtor, this would approach the problem of litigation exclusively from an inter-creditor perspective, that is, creditors would have some assurance that their forbearance through the negotiating process would not be abused by an aggressive litigant.

The hotchpot rule is not without shortcomings, however. First, if the judgment creditor is able to obtain more through litigation than it would receive under the agreement, the agreement would not affect the creditor. Second, when a creditor had purchased its claim at a deep discount, the rule would still not deny the creditor a significant profit, even if it were only able to collect on its judgment in part. This could be particularly problematic when prospects for an early restructuring after activation are very uncertain; in such a case, the creditor may judge that, under the circumstances, it makes more sense to secure a profit immediately through litigation than to wait for a restructuring agreement to be reached.

The second measure, designed in part to address the above limitations, would enable creditors to prevent litigation even before the verification process had been completed, that is, before a general, creditor-approved stay could become operational.<sup>177</sup> Upon the request of a representative creditors committee, specific creditor enforcement measures could be enjoined, that is, the stay would be of a targeted rather than of a general nature. Since, as discussed below, the SDRM would create incentives for the early establishment of creditors’ committees, such actions could occur relatively soon after activation. To avoid the risk of discrimination among different creditor groups,

the activation of the stay would require a determination by the Dispute Resolution Forum that the litigation in question was particularly disruptive to the restructuring process.<sup>178</sup> One of the disadvantages of this measure is that it would expand the role of the Dispute Resolution Forum, something that was of particular concern for members that had reservations about the adverse effect a new supranational entity would have on national sovereignty.

Notwithstanding the development of these various alternative measures, a number of the IMF's Executive Directors remained convinced that the SDRM could only be effective if, upon activation, a general stay on enforcement was imposed automatically, albeit temporarily. Accordingly, the IMF was unable to make an unqualified recommendation on this important feature.<sup>179</sup> Their perspective reflected, at least in part, a belief that the SDRM could only fulfill its objective if there was a general stay on payments by the debtor following activation. They were not convinced that a country whose debts were truly unsustainable would be able to engineer a restructuring without a general standstill on all payments. This view may have been shaped by sentiments within the official sector that firm access limits on IMF financing was the key to the orderly resolution of financial crises. There may have been a concern that such limits could only be effective if there were adequate assurances that, as an alternative to such financing, the members would stop the outflow of all capital once the restructuring process was launched.

### **Improving the Dialogue**

The Proposed Features contain two elements tailored to improve both debtor-creditor and inter-creditor dialogue during the restructuring process. The first is the establishment of a requirement that the sovereign debtor provide comprehensive information to creditors at an early stage in the process.<sup>180</sup> The second is the envisaged role of a representative creditors' committee.<sup>181</sup> The purpose of these components is not just to make the restructuring process more collaborative, but also to make it more rapid and predictable.

### *Provision of Information*

As in the corporate context, a creditor will feel that it is in a position to accept or reject a restructuring proposal only if it has sufficient information. The absence of timely and relevant information will both fuel suspicion and delay completion of the restructuring process. In the sovereign context, this information will fall into two categories. The first category embraces information that explains the nature of the economic problems and the circumstances that justify the terms of the proposed restructuring. It also includes the broad outline of the economic strategy that will restore medium-term sustainability and, therefore, provide some basis for concluding that the debtor will, in fact, be able to service its restructured debt. The second category of information is designed, in large part, to address inter-creditor equity considerations: it includes a detailed description of the debt owed by the sovereign and how this debt will be treated under the restructuring proposal.

The establishment of an economic program supported by IMF resources will normally provide the basis for the availability of the first category of information. The macroeconomic program underlying an IMF arrangement would normally define the country's economic situation, its present and future policies, and its medium-term payments capacity. Under the IMF's existing policy on transparency, program documents are generally published at the time the arrangement is approved or when reviews under the arrangement are concluded.<sup>182</sup>

The features of the SDRM proposal focus on the timely disclosure of the second category of information. Upon activation of the SDRM, the sovereign would provide the Dispute Resolution Forum all known information regarding its indebtedness, which would be made available on a website maintained by the Dispute Resolution Forum.<sup>183</sup> This information would be organized into three lists.

The first list would consist of all debt that the sovereign intends to restructure under the SDRM (SDRM Restructuring List). Claims included on this list would be identified as specifically as possible (face value, contracting and due dates, and identity of the holder of record). Since the only claims that could be restructured under the

SDRM are those included on the SDRM Restructuring List, the sovereign would have an incentive to make the list as comprehensive as possible.

The second list would consist of claims that are being restructured outside the SDRM (Non-SDRM Restructuring List). This would include all domestic debt being restructured and—depending on the scope of the debt covered under the SDRM—would also include all official bilateral debt that is being restructured.

The third list would include all claims that the sovereign does not intend to restructure (Nonimpaired List). As noted earlier, it is likely that, in the sovereign context, there will be private claims that the sovereign wishes to continue to service and to exclude from the restructuring process.<sup>184</sup>

Thus, while certain claims would not be restructured under the SDRM, the procedure it establishes would provide for full transparency as to how this debt is being treated. The information provided by the sovereign debtor would be expected to evolve. For example, for reasons of inter-creditor equity, creditors that find themselves on the SDRM Restructuring List may insist that, as a condition for their support, certain claims be moved from the Nonimpaired List to the SDRM Restructuring List. Moreover, the SDRM Restructuring List may also expand in light of economic developments. Finally, when a sovereign has actually proposed a restructuring agreement, it would also be required to provide information as to the terms it is offering to creditors that are being restructured outside the SDRM.<sup>185</sup>

### ***Creditors' Committees***

During the 1980s, most of the restructuring of sovereign debt occurred within a structured negotiating framework, with a representative creditors' committee playing a central role.<sup>186</sup> These committees performed a number of functions. First, they provided an important method of forging a common position among creditors. This was achieved through the reliance on a single financial and legal advisor who was responsible for negotiating among creditors and who was retained by the committee rather than by individual creditors. Second, they established an effective vehicle for assessing and

“selling” a restructuring proposal. Although a committee could not legally bind the general creditor body, a decision by the creditors on the committee to accept the restructuring terms carried considerable weight. Third, and perhaps most important, creditors’ committees could serve as the negotiating counterpart for the sovereign debtor because they were able to provide credible assurances as to the confidentiality of information provided by the debtor, including preliminary restructuring proposals.

However, as a result of the evolution of capital markets, the establishment and operation of creditors’ committees has become more complicated. It is more challenging to secure adequate representation of creditors where the debt is widely dispersed among different creditors with diverse economic interests.<sup>187</sup> The fact that debt instruments trade constantly on the secondary market also makes it more difficult to establish a stable representative group of creditors. Finally, there is also a perception that it has become more difficult for a committee to provide credible assurances that the information it receives from the debtor during the negotiations will be kept confidential. Unlike large commercial banks, a number of investors who purchase large amounts of emerging market debt are too small to implement firewalls capable of ensuring confidentiality.<sup>188</sup>

Notwithstanding these challenges, progress has been made in identifying best practices that could guide the formation and operation of creditors’ committees in this new environment. Not surprisingly, these principles draw upon the experience in the nonsovereign context, where the operation of creditors’ committees has also had to adjust because of the disintermediation of credit.<sup>189</sup> The committees themselves have drawn on work principles established to guide the formation of committees in the nonsovereign context, perhaps the most elaborated being the “Principles for Sovereign Debt Restructuring” prepared by the Council of Foreign Relations.<sup>190</sup> In light of progress in this area, creditors who have been complaining about the use of take-it-or-leave-it exchange offers by sovereigns have clamored for the actual application of such practices in the sovereign context. The IMF has also adjusted its lending policies to accommodate greater reliance on creditors’ committees. In 2000, it revised its lending-into-arrears policy to provide that, in circumstances in which an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors

have been able to form a representative creditors' committee on a timely basis, there would be an "expectation" that the member would enter into good-faith negotiations with this committee.<sup>191</sup> The failure of the member to satisfy this expectation would be taken into consideration by the IMF when determining whether it would continue to provide financing.<sup>192</sup>

Consistent with the above, the SDRM proposal also anticipates reliance on creditors' committees. In addition to the general function of resolving both inter-creditor and debtor-creditor coordination, it was envisaged that, under a framework that aggregates creditor claims for voting purposes, the committee could play a number of additional specific roles. For example, during the voting process, a subcommittee could be established for the specific purpose of determining whether registered claims should be challenged when evidence suggests that the creditor is not independent of the sovereign. In addition, as noted earlier, approval by the creditors' committee could also be a condition for approval of an order that would enjoin specific enforcement actions.<sup>193</sup>

The SDRM proposal would not mandate the formation of creditors' committees. Consistent with the approach taken by the IMF under its lending-into-arrears policy, these committees would participate in the process in those circumstances in which creditors have taken the initiative to establish one.<sup>194</sup> Drawing on the approach relied upon in the nonsovereign context, the Proposed Features contain two specific features that address issues relating to the establishment and operation of committees. The first relates to the question of when a committee would be "representative." While several broad criteria could be relied upon to make this determination,<sup>195</sup> it was recognized that the application of these criteria would give rise to disputes. Consistent with the approach taken in the insolvency context, where these disputes are brought before a court of competent jurisdiction, such disputes would be resolved by the Dispute Resolution Forum.

The second feature relates to the expenses of the creditors' committees, an issue that has proved to be rather controversial. As noted earlier, one of the means by which creditors' committees can assist in forging a common position among creditors is through the retention of a single financial and legal advisor that represents the



committee as a whole rather than individual creditors. In the nonsovereign context, a number of laws provide that these fees, and other reasonable expenses associated with the operation of the committee, shall be borne by the debtor.<sup>196</sup> As a matter of practice, a similar approach was taken during the sovereign debt restructurings that took place in the 1980s, in which the expenses of the steering committees were also borne by the sovereign.<sup>197</sup> One of the advantages of this approach is that of inter-creditor equity. Although the fees are nominally paid by the debtor, they actually are paid with resources that would otherwise be made available to all creditors under the restructuring proposal. Accordingly, this ensures that costs are borne by creditors (in terms of a reduction in the payments that they would have otherwise received) on the basis of their exposure. On this basis, IMF staff proposed that the SDRM would clarify that the sovereign debtor would bear the reasonable costs incurred by a representative creditors' committee. To the extent that the sovereign debtor and creditors disagreed on the fairness of such fees, such disputes would be resolved by the Dispute Resolution Forum.

During the external consultation process, however, this emerged as a polarizing issue. Several representatives of a number of emerging market sovereigns were of the view that the proposal was politically unacceptable. They noted that, during the debt crisis of the 1980s, it had been very difficult to explain to parliaments why it was necessary for a country in the midst of a crisis to bear the fees and expenses of well-heeled investment bankers and lawyers. For this reason, memorializing such an approach in the text of the SDRM was bound to attract considerable opposition. In the end, the question of the payment of fees for creditors' committees remained one of the unresolved issues in the SDRM proposal.<sup>198</sup>

### **Priority Financing**

During the restructuring that took place in the 1980s, it was relatively common for creditor banks to provide new financing to the sovereign while the negotiations were proceeding. Among other things, this financing allowed the sovereign to remain current on interest payments, thereby enabling the creditor bank to continue to classify the loan as a performing one for regulatory purposes.<sup>199</sup> When such financing was provided, there was an understanding among all of the other banks engaged in the process that this debt would be

given priority, inasmuch as it would be excluded from the debt restructuring process.<sup>200</sup> However, this understanding was not reduced to a legally binding inter-creditor agreement.

During the development of the SDRM proposal, there was considerable discussion as to the potential benefits of including a provision that would create incentives for a similar type of priority financing. To the extent to which such financing was available, it would—among other things—reduce the amount of financing that would need to be provided by the official sector during this period. For those concerned with the moral hazard created by IMF financing, this has been considered a particularly important element of any potential legal framework.<sup>201</sup> However, given the evolution of capital markets, it is unlikely that the informality of the incentive structure relied upon in the 1980s would be feasible.<sup>202</sup> The banks that had been willing to provide priority financing did so, in part, because it would facilitate a more orderly restructuring of their own claims. In today's environment, the holders of bonds that are subject to a restructuring would normally not be in a position to provide new financing. Moreover, the nonbinding understandings regarding the exclusion of priority financing were predicated on the existence of a small number of creditors with similar interests—hardly a description of the atomized and diverse creditor community that exists today.

In light of the above, a difficult issue was how to design the SDRM proposal so that creditors would have adequate assurances that any new financing by them would, in fact, be given priority. The approach that was eventually adopted would allow for a qualified majority of creditors whose claims are being restructured to decide that a certain financing would be excluded from the restructuring process. The exclusion of such financing from the SDRM would be made effective through the requirement that the Dispute Resolution Forum could not certify a restructuring agreement that contravened this exclusion, unless the creditor that had provided this priority financing agreed to allow its claim to be restructured.<sup>203</sup> Creditors could decide to grant priority to a particular credit transaction or, alternatively, to a specified aggregate amount of financing that satisfies prespecified terms, such as maturity, and so forth.

There are shortcomings to this approach. Most important, the assurance provided to the priority creditor is a limited one,

particularly when compared to those that are received by a creditor in the corporate context. Under many insolvency laws, in the event the reorganization process fails, the proceedings will be converted into a liquidation, at which point all creditors who have extended post-petition financing will receive priority in distribution vis-à-vis other unsecured creditors.<sup>204</sup>

To provide greater inducements for new financing, consideration was also given to establishing a form of inter-creditor subordination. When creditors voted to exclude a particular financing transaction from the restructuring process, they would also vote to approve an agreement that would bind them—and the minority of dissenting creditors—to a subordination agreement with the priority creditor: in the event that the priority creditor had not been paid in full by the sovereign debtor, existing creditors would agree to transfer to the priority creditor any amounts they might receive from the sovereign until the priority creditor was made whole. This feature was not included since it was considered to interfere with contractual relations to an unnecessary extent. A minority creditor that had dissented from the agreement would not only be forced to accept that a priority creditor would be excluded from the terms of the restructuring, but it would also be liable to this creditor for any amounts that it received from the sovereign until the priority creditor in question was made whole.

While the priority financing feature of the SDRM proposal is not particularly robust, there would, of course be other means of inducing a creditor to provide financing during the restructuring process. Perhaps most important, a sovereign could offer collateral.<sup>205</sup> While its ability to do so could be constrained by the existence of negative pledge clauses contained in existing bonds, these provisions could be amended through the use of contractual provisions that allow for the amendment of nonpayment terms by a specified majority.<sup>206</sup> Moreover, the official sector could facilitate the provision of such security by waiving the application of the negative clauses contained in loans provided by multilateral development banks.<sup>207</sup>

### **Voting and Classification**

The perceived benefits of a legal framework that would enable different instruments to be aggregated for voting purposes was one of

the key motivations behind the SDRM proposal. To the extent that one accepts the premise that collective action difficulties are exacerbated by the multiplicity of instruments and the growing diversity of creditor interest, this feature is critical. Moreover, if appropriately designed, it can enhance creditor coordination and, as observed below, may also provide greater clarity and predictability with respect to the resolution of inter-creditor equity issues.

At the same time, however, aggregation carries with it a number of risks, including the potential for manipulation, inter-creditor discrimination, and, finally, inflexibility. Accordingly, when the SDRM proposal was being designed, the key challenge was to minimize these risks while maximizing the benefits of aggregation. Fortunately, a number of these issues arise also in the context of the restructuring of corporate debt and, for this reason, the development of the SDRM proposal benefited considerably from the experience that had accumulated regarding both the design and implementation of the voting provisions of domestic insolvency laws.<sup>208</sup>

### ***Ensuring Integrity***

Any framework that allows for aggregation of claims for voting purposes may be subject to abuse unless certain safeguards are in place. In the sovereign context, there are several different types of risk. First, creditors may attempt to inflate the value of their claims. Moreover, to avoid being subject to the SDRM altogether, they could try to overstate the value of collateral that secures their claim. Second, a debtor may attempt to create fictitious claims by, for example, making a private placement to an entity that it controls, but without receiving any value from that entity. The creation of such fictitious claims can distort the voting process, since the sovereign debtor can ensure that these claims vote in a manner that results in onerous terms for the holders of valid claims. Moreover, since these claims would be recognized under any restructuring agreement, they would reduce the amount received by valid creditors. Finally, even if the claims in question are valid, there is a risk that, as noted above, the creditor would be owned or controlled by a sovereign debtor, such as a state-owned bank.

Drawing on the features of modern insolvency laws, the Proposed Features establish a claims verification and voting procedure designed

to address these risks.<sup>209</sup> As noted earlier, creditors whose claims appeared on the SDRM Restructuring List and who wished to participate in the voting process would have to register their claims within a specified period.<sup>210</sup> To register, a creditor would identify itself as the holder of the claim in question and state the value of its claim. A registered claim would be considered to be verified unless it was challenged within a specified period after registration.<sup>211</sup> This would give both the sovereign and the creditors the opportunity to challenge the value or validity of the claim; any dispute arising from this process would be resolved by the Dispute Resolution Forum. Even if the value or validity of the claim is not challenged, a verified claim could still be excluded from the voting process if, following a challenge by a creditor, it was determined that it was owned by a creditor that was owned or controlled, directly or indirectly, by the debtor. Such claims would nevertheless be considered as valid for distribution purposes.<sup>212</sup>

What of those entities over which the sovereign exercises influence but not ownership or control? This would include, for example, privately owned financial institutions that are subject to the regulatory powers of the government or the central bank. While the criteria of direct or indirect ownership and control are sufficiently objective to enable them to be effectively applied in a statutory framework, operationalizing the concept of “influence” is clearly more challenging. Since it would require the exercise of considerable discretion by the Dispute Resolution Forum, the decision was made not to include it within the Proposed Features. It was recognized, however, that the potential for abuse in this area was somewhat mitigated both by the aggregation process and by the proposed exclusion of claims governed by domestic law from the SDRM. Specifically, while it may be possible for a sovereign to exert enough influence over domestic banks and other domestic entities to distort the voting of a single bond issuance, it will be more difficult to do so when all foreign law instruments are aggregated.

### ***Discrimination Among Private External Claims***

The Proposed Features envisage that, as a general rule, all creditors that appeared on the SDRM Restructuring List would be bound to the restructuring terms that had been agreed to by creditors representing 75 percent of the outstanding principal of registered and

verified claims.<sup>213</sup> To avoid discrimination, the general rule would also require that all creditors receive the same terms—or menu of terms—under the restructuring agreement.<sup>214</sup> This would prevent discrimination when all creditors have the same type of claims against the sovereign; the rule would prevent a majority from agreeing to terms that would give them preferential treatment vis-à-vis the minority of creditors holding the same claims.

Of course, if one aggregates claims that are of varying degrees of seniority, the application of the above rule can also result in discrimination. Although the concept of seniority in the sovereign context is not entirely straightforward, this concern was one of the motivations, as discussed earlier, for excluding secured and domestic law claims from the scope of the SDRM.<sup>215</sup> It also explains why consideration was given to placing official bilateral claims in a separate class for voting purposes. During the discussion of the SDRM, the question also arose as to whether discrimination might also arise as a result of the aggregation of unsecured claims of private creditors that have different maturities or interest rates. For example, would there not be a risk that holders of long-term bonds representing more than 75 percent of all claims would vote for a restructuring that would provide, *inter alia*, for a significant lengthening of maturities of all short-term maturities?

In a post-default environment, the problem is easily resolved. As long as all claims are accelerated by the time the restructuring agreement is proposed, all creditors can be treated as having claims of the same maturity, since all amounts outstanding are due and payable.<sup>216</sup> The concern remains, though, as to restructurings that are proposed prior to a general default and, therefore, prior to any acceleration. Offering unsecured creditors the same terms would presumably only be acceptable if the risk of imminent default were high enough that creditors were willing to treat all of their claims as having been accelerated. Interestingly, in the corporate context, this issue also arises under “prepackaged insolvency proceedings,” when the debtor and its creditors agree upon a restructuring arrangement prior to the commencement of formal insolvency proceedings and when the debtor is continuing to service its obligations.<sup>217</sup> Under such arrangements, formal insolvency proceedings are commenced for the exclusive purpose of making the agreement binding on the entire creditor body. When the agreements are being negotiated, unsecured

creditors holding claims with different maturities are generally willing to be given the same treatment under the restructuring agreement because they have reached the conclusion that a general default is imminent. Provided that the SDRM was only available for unsustainable cases, it is likely that creditors would also be willing to be treated in the same manner since, in such cases, a generalized default may be excepted in the absence of a restructuring.

### *Optional Classes*

In the corporate insolvency context, a classification system also provides a means by which the debtor can enhance the chances that a restructuring proposal will be acceptable. Specifically, while the law gives it the right to place all unsecured creditors in the same class, it may find it in its interest to place them in separate classes so that they can be provided with different treatment, taking into account the different preferences of the creditors in question.<sup>218</sup> This may also be of relevance in the sovereign context. For example, a sovereign may feel that it may be able to offer terms to domestic banks holding external claims that are less favorable than those offered to external creditors holding similar claims. Domestic banks may be willing to accept inferior claims in exchange for some regulatory forbearance. The creation of separate classes in these circumstances allows for differential treatment while, at the same time, preserving the antidiscriminatory principle that all creditors in the same class be offered the same terms or at least the same menu of terms.<sup>219</sup>

Given the above benefits, the Proposed Features gave the debtor the option to create such classes when it concluded that the provision of differential treatment could increase the likelihood of a successful restructuring.<sup>220</sup> The key benefit of such “optional” classes was flexibility; while the SDRM proposal would allow for full aggregation of private claims within a single class, some degree of disaggregation—through the creation of different classes—could also be achieved if some differentiation in treatment among creditors provided the most effective means of achieving a sustainable restructuring.

Allowing for classification for this purpose raises potential for abuse. For example, there is a risk of “gerrymandering,” that is, a risk that creditors would be placed in artificial classes for the sole purpose

of engineering a successful restructuring.<sup>221</sup> To address this risk, the Proposed Features contained at least two important safeguards. First, as noted above, any restructuring proposal would only become effective if a qualified majority of creditors from each class supported the proposal. To the extent that a group of creditors objected to being placed in a separate class and being given separate treatment, they could simply exercise their veto to reject the proposal, in which case the sovereign would need to either make the offer more attractive or place these creditors in the general class. Second, the SDRM would include a rule to the effect that classes may not be created in a manner that could result in unjustified discrimination among creditor groups, taking into account their varying economic interests.<sup>222</sup> No doubt, there would be disputes as to whether classification is discriminatory in a particular case. Such disputes would be resolved by the Dispute Resolution Forum, to which we now turn.

### **Dispute Resolution Forum**

In developing the SDRM proposal, there was a recognition from the outset that the aggregation of claims for voting purposes would require the establishment of some independent and centralized forum that would oversee the implementation of the legal framework. This oversight would include both the administration of the registration, verification, and voting procedure and the resolution of disputes that would inevitably arise in that context. One of the recognized advantages of establishing such a forum through a universal treaty, such as the IMF's Articles of Agreement, is that it would ensure that a centralized forum could be created with exclusive jurisdiction and authority over these matters.

Discussions surrounding the design of such a forum—the Dispute Resolution Forum—attracted considerable attention both within and outside the IMF, with two central issues emerging. First, there was the need to balance the imperative of giving the DRF adequate powers to facilitate an orderly and rapid restructuring process, against concerns regarding the establishment of a new supranational entity: would it impose some limits on state sovereignty? Second, was it possible to establish a dispute resolution forum through an amendment of the IMF's Articles of Agreement that would be independent—and be perceived as being independent—from the



IMF? The design of the DRF, outlined in the Proposed Features, was largely shaped by the discussion of these two issues.<sup>223</sup>

### ***Powers of the DRF***

In some respects, the dispute resolution functions of the DRF would resemble those of a court having jurisdiction over insolvency proceedings. In terms of subject matter, many of the disputes arising between the debtor and its creditors and among creditors would revolve around the registration, verification, and voting process; as is the case under typical insolvency proceedings, challenges would be made regarding the value or legitimacy of a claim submitted for verification.<sup>224</sup> Even if a claim were valid, a creditor may wish to exclude it from the voting process on grounds that it is controlled by the sovereign. In addition, disputes may arise as to whether, for example, a creditors' committee is adequately representative and whether its fees are excessive.<sup>225</sup> As with most domestic courts, the DRF would play a purely reactive role in the dispute resolution process. Rather than issue its own challenges, it would rule on challenges brought by parties in interest.

Unlike domestic courts, there was a reluctance to give the DRF subpoena powers. Not only would the exercise of such powers against a sovereign debtor be problematic, but there was some discomfort expressed about such powers being used against creditors. This does not mean there would be no sanctions against misbehavior, however. To the extent, for example, a creditor did not provide adequate information to enable the DRF to determine whether a challenge to the validity of its claim had any merit, the claim would be excluded.

What law would the DRF apply when resolving disputes? In terms of the substantive law, there was consensus that the relevant national law would be used. Thus, for example, on questions relating to the validity of the claim, the law of the contract would apply, unless there was a dispute on whether the official of the debtor had the authority to enter into the underlying agreement, in which case the law of the sovereign debtor would be relied upon. However, on procedural issues that could be expected to arise during the implementation of the SDRM—for example, abuse of the voting process—it was agreed that the DRF would develop and apply its own rules.

Consistent with the desire to create a forum with very limited powers, there was considerable reluctance to give the DRF the authority to issue legal rulings in particular proceedings outside the context of a dispute. In the domestic insolvency context, the authority of the bankruptcy court to rule outside the context of a dispute often does exist, perhaps most importantly at the conclusion of the proceedings where some laws give the court the authority to veto a restructuring proposal that has been agreed upon by the debtor and the requisite majority of creditors, if it determines that the plan is not feasible.<sup>226</sup> Under the SDRM, however, there would be no opportunity to second-guess judgments made by creditors regarding the viability of a restructuring plan.<sup>227</sup> This reflected the more general belief that, to the extent possible, the DRF should not have the authority to exercise broad discretion on economic issues, particularly since, in the sovereign context, the resolution of such issues will often require making judgments on political matters.<sup>228</sup>

Nevertheless, the DRF would perform important administrative functions. To be effective, the SDRM proceedings would need to be organized and overseen by some independent body, and it was decided that the DRF would perform this task. This would involve ensuring that creditors were notified that a proceeding had been commenced; organizing the registration, verification, and voting process; and certifying that the requisite percentage of creditors had, in fact, voted in favor of a debt restructuring proposal. These administrative functions would be performed by a very small permanent secretariat, rather than by the members of the DRF itself.<sup>229</sup>

In that context, the issue of rule-making authority raised difficult issues. As work on the SDRM proposal progressed, it became increasingly clear that, no matter how streamlined its design, there would need to be a number of technical rules that it would be inappropriate to specify in the treaty itself.<sup>230</sup> These rules ranged from procedural rules for registration, verification, and voting to those that would provide further definition to general concepts set forth in the treaty, such as when a creditor would be considered “under the control of the debtor.” Given the desire to circumscribe the DRF’s powers, there was some understandable reluctance to give it such rule-making authority. At the same time, however, the ability to

promulgate—and amend—rules on relatively technical issues was critical if the SDRM was to be sufficiently flexible to adapt to the evolution of the international monetary system.<sup>231</sup> As a means of addressing concerns regarding the granting of excessive powers to the DRF, the Proposed Features provide that rules adopted by the DRF would enter into force unless overruled by the IMF's Board of Governors by an 85 percent majority of the total voting power.<sup>232</sup>

### ***Legal Effect of DRF Actions***

One of the lynchpins of the SDRM proposal is the legal effect of DRF actions, with perhaps the most profound action being a purely administrative one. Specifically, once the DRF has certified that a restructuring agreement has been reached between the debtor and the requisite majority of creditors, this certification would have a direct binding effect in all countries that are members of the IMF and could not be challenged in any domestic court. Accordingly, a creditor that had dissented during the voting process could no longer enforce its claim under the original agreement. Similarly, a certification by the DRF that creditors had voted for a stay on enforcement would also preclude enforcement actions in all domestic courts of IMF members. Finally, decisions rendered by the DRF in the dispute resolution process would not be subject to challenge in domestic courts during the restructuring process or after an agreement had been reached. For example, if, during the verification process, the DRF determined that the value of a claim was less than the value asserted by the creditor, the creditor could not reopen this issue in a local court once a restructuring agreement had been certified.

Of course, the binding effect of such actions assumes that all member countries have taken the necessary steps to ensure that the new treaty obligations conferring such powers on the DRF are given full legal effect in their territory.<sup>233</sup> While, in some countries, the entry into force of the amendment would automatically have such effect, in others it would require the incorporation of these obligations into domestic law. During the discussion of the SDRM proposal, the question arose—both inside and outside the IMF—whether domestic legal systems of member countries would allow for the framework to apply to claims in existence prior to the effective date of the SDRM.<sup>234</sup> Clearly, this is a question for each country to resolve under its own domestic law. However, based on the tolerance that most

legal systems have shown to the application of new insolvency laws—or amendments to those laws—to existing claims, it was recognized that it would probably not be a significant problem in the sovereign context. For example, the resolution of the crisis that swept Asia during the late 1990s required a comprehensive restructuring of the debt of the corporate sector, much of which was denominated in foreign exchange.<sup>235</sup> A central feature of the corporate restructuring strategy was the strengthening of domestic insolvency laws.<sup>236</sup> As in the corporate context, the decisions that would modify existing claims would generally be those taken by a qualified majority of creditors—not by the DRF—who would clearly be motivated by a desire to enhance rather than diminish the value of their claims.

### ***Institutional Features***

The efforts by the IMF to design a DRF that was independent, competent, and impartial involved considerable outreach. In addition to consulting closely with members within the legal and juridical community, the staff drew upon the considerable body of precedent in the international law area.<sup>237</sup> Of particular relevance were other treaties establishing international organizations that include adjudicative organs that are independent—and perceived as being independent—from the other organs of the organization. A prime example is the International Court of Justice, which is an organ of the United Nations.<sup>238</sup> One does not have the perception that, by virtue of it being part of the UN, the decisions of this court are influenced by the Security Council or the General Assembly. In designing the DRF, the challenge was to ensure that its independence was both *de jure*—that is, through specific provisions in the treaty that insulated the organ from interference from the IMF’s Executive Board and the Board of Governors—and *de facto*.<sup>239</sup> During the discussion, it became increasingly clear that the single most important factor in ensuring *de facto* independence was the process through which the members of the DRF were selected and appointed.

When approaching the issue of selection and appointment, the IMF was attracted by the approach relied upon by the International Center for the Settlement of Investments Disputes, the World Trade Organization, and the North American Free Trade Agreement. Specifically, while the SDRM would provide that a permanent pool of judges would be selected in advance to serve on the DRF, an

adjudicative panel would only be created from this pool once a crisis arose. This approach would avoid the creation of a permanent cadre of judges located in Washington that could be suspected of falling under the influence of the staff or Executive Board of the IMF. Until judges that form part of the pool were impaneled, they would continue to work in their own countries and in their other capacities. At the same time, however, the existence of a permanent pool would mean that a dispute resolution panel could be in place quickly once a crisis arose.

Perhaps more than anything else, the credibility of the DRF as an independent and competent body would be based on the fact that parties outside the IMF would play a role in the selection process. The framework envisages a three-step procedure. The first step involves the appointment of a panel that would, in turn, be responsible for selecting the permanent pool of judges. While the IMF's Managing Director would formally appoint the selection panel, he or she would do so on the advice of professional associations of corporate insolvency and debt restructuring experts, such as the International Federation of Insolvency Professionals (INSOL), and public or private international organizations that have developed expertise in insolvency and debt restructuring matters, such as the United Nations Commission on International Trade Law (UNCITRAL).<sup>240</sup>

The second step would involve the selection of the pool of 12–16 candidates that would constitute the pool of judges.<sup>241</sup> An open nomination process would be used, thus enabling the selection panel to receive names from member governments of the IMF and from civil society. In making their selection from the nominations, the selection panel would be guided by the selection criteria set forth in the treaty.<sup>242</sup> While there was a recognition that the treaty should also require a diversity of legal backgrounds, diversity should not come at the expense of competence. Specifically, when assessing competence, the panel would need to take into consideration whether the nominees had expertise in the laws that govern international sovereign debt instruments. Accordingly, to the extent that the laws of several jurisdictions—New York, England, Japan, and Germany—dominate the existing market, this would need to be taken into consideration. Since it was envisaged that the new pool would be selected every five to six years, adjustments would be made, depending on developments in the sovereign debt market.

The final step would involve the impaneling of four members of the pool once a crisis arose. After considerable consultation with members of the judicial and legal profession, IMF staff recommended that one of the four members of the Dispute Resolution Panel would be the supervisory judge, responsible for overseeing the case and making initial determinations; the remaining three would constitute an appeals panel.<sup>243</sup> The method by which the four would be impaneled attracted considerable discussion. Clearly, the notion of allowing the parties to the dispute to select the panel from the available pool—along the lines used for arbitration proceedings—would be unworkable given the fact that one would need to forge a common position among a multitude of creditors. Moreover, since the selection would precede the verification process, one could not even be sure that the creditors involved in selecting the panel would, in fact, be creditors.

The approach that was eventually recommended was to have the president of the DRF—who would be elected for a fixed term by the entire pool of judges—select the panel in a manner that ensured impartiality. One could envisage various ways in which to secure the impartiality of the impaneling process. For example, the president could develop a secret list in consultation with the pool of judges, where a number of panel members would agree to be available for a particular month or calendar quarter. Of course, when applying this system, the president would need to ensure that the judges that are on call when the crisis arises do not have any conflicts of interest in the particular case. It was recognized that this approach would require that the president of the DRF—unlike all other judges—would be permanently located in Washington.

While the independence of the proposed DRF may have gone a long way toward addressing the concerns of academics and members of civil society concerned with the impartiality of the DRF, it may have unsettled those in the official sector who were more concerned with the implications of such independence. While national governments may be able to exercise their influence in decisions made by the IMF's Executive Board and Board of Governors, this would not be the case with the DRF. Accordingly, as greater clarity emerged as to the independence of the DRF, the pressure grew to ensure that the powers of the DRF were carefully circumscribed.<sup>244</sup>

## Conclusions: Understanding the Resistance

No analysis of the SDRM proposal is complete without some inquiry as to why support from the official sector, while strong, was not sufficient to ensure its adoption. A closely related question is why the private sector remained so virulent in its opposition.

Since an amendment of the IMF's Articles of Agreement requires the support of three-fifths of its members holding 85 percent of the voting power,<sup>245</sup> the support of the United States—which currently holds 17.14 percent of the IMF's voting power—was a necessary condition. Initially, the signals were positive. In September 2001, then-Secretary of the Treasury Paul O'Neill, in testimony to the Senate Banking Committee, stated, "We need an agreement on an international bankruptcy law, so that we can work with governments that, in effect, need to go through a Chapter 11 reorganization instead of socializing the cost of bad decisions."<sup>246</sup> As time went by, however, it became increasingly clear that the United States was willing to embrace only the "contractual approach" and that further work on the design of the SDRM proposal should be dropped.<sup>247</sup>

The decision of the United States to turn away from the SDRM proposal may have been motivated by several related factors. First, early consideration of the SDRM proposal was based on the absence of progress in the more incremental contractual approach. Given the breakthrough that occurred with the introduction of collective action clauses in New York law-governed bonds in early 2003, more radical reform may have appeared less necessary.<sup>248</sup> Second, and more generally, as the shape of the statutory framework began to emerge, there may have been serious doubts within the U.S. government as to whether there was any realistic chance that it would gain congressional approval.<sup>249</sup> No matter how streamlined the SDRM proposal became, its provisions would still interfere with the contractual claims of U.S. investors. Moreover, the jurisdiction of the DRF, although limited, would supersede that of the U.S. courts during the restructuring process. For European countries, which had grown rather accustomed to resolving economic and financial issues through the establishment of treaty obligations and supranational institutions, this type of reform was not particularly novel. For U.S. lawmakers, however, it would have represented a major step.<sup>250</sup> The concerns of the U.S. government regarding the SDRM proposal's reception in

Congress may also have been heightened by the fact that the SDRM would be created through an amendment of the IMF's Articles of Agreement. As a powerful and relatively controversial international financial institution, any amendments to the IMF's charter were bound to attract considerable scrutiny. Indeed, even if lawmakers supported the SDRM proposal, there may have been a concern that they would want to use the opportunity to press for other reforms to the IMF that may not have been supported by the administration.

But another critical factor behind the U.S. position was most likely the steadfast opposition to the SDRM proposal by the major financial industry associations.<sup>251</sup> Not only did such opposition make it much more difficult for the SDRM proposal to be approved in Congress, but there was clearly a reluctance within the U.S. government to forge ahead with such an important reform of the international financial system when a key stakeholder in that system—the private sector—was so resistant. Opposition to the SDRM proposal by financial industry associations was, of course, also an important reason why a number of emerging market countries opposed the SDRM proposal. The private sector consistently warned that the SDRM, if adopted, would adversely affect the volume and price of capital to these countries.<sup>252</sup>

The source of the private sector's concern with the SDRM proposal merits some analysis. The issue is complicated by the fact that it did not always speak with a single voice. European and Asian financial institutions were less openly hostile to the SDRM proposal than their U.S. counterparts. Moreover, industry associations made up of investors that actually purchased and held sovereign debt (the "buy-side") were more willing to engage in discussions regarding the design of the SDRM proposal than those responsible for actually placing new bond issuances for emerging market sovereigns (the "sell-side").<sup>253</sup> Nevertheless, all voiced concern with the fact that the SDRM proposal would limit the rights of individual investors, something they found particularly disturbing given the general view that creditor rights against a sovereign were already very fragile.<sup>254</sup> In their view, collective action problems in the sovereign context were not of a sufficient magnitude to merit the degree of official intervention that the SDRM entailed. More generally—and not surprisingly—they expressed a strong preference for resolving such



problems through self-regulation rather than official intervention.<sup>255</sup> Hence, their belated embrace of collective action clauses.

The evolution in the design of the SDRM proposal did nothing to allay these concerns. On one level, this may seem somewhat surprising since, in its final form, a number of features of the proposal could be described as enhancing rather than reducing creditor leverage; namely, the creditor-approved stay, the introduction of transparency requirements, and the role envisaged for creditors' committees. While the aggregation of claims across instruments for voting purposes would give rise to interference with contract, it is not clear that this feature, on its own, was the source of all of their anxiety. Indeed, the potential benefits of aggregation have been recognized by the private sector itself, and, as noted above, some elements of an aggregated framework were successfully incorporated into the bonds recently issued by Uruguay, albeit in a limited form.<sup>256</sup>

In the final analysis, it is possible that the private sector's opposition was also attributable to suspicions regarding the SDRM's motivation, not just its design. Indeed, the leading financial industry associations appeared to acknowledge this in a letter signed in December 2003, in which they stated that "no changes in its specifics will alter our serious concerns about the SDRM's inherent problems."<sup>257</sup> As noted in the economic press, it is possible that they were afraid that the SDRM was simply designed to increase the frequency of restructuring and, thereby, reduce the frequency of large financing packages from the IMF.<sup>258</sup> As discussed herein, however, the SDRM proposal was never intended by the IMF to replace large financing packages. Rather, it was intended to provide a framework for the restructuring of unsustainable debt, that is, debt that would have to be restructured no matter how much financing was made available.<sup>259</sup>

What implications can one draw from the above regarding the prospect of establishing a statutory sovereign debt restructuring framework in the future? To the extent that future experience shows that the restructuring of unsustainable sovereign debt under the existing system is excessively costly, the attitude of creditors toward a statutory framework may evolve. While the private sector would understandably object to any legal framework that it suspects—rightly or wrongly—will make restructurings more likely, it may have

a different attitude toward a framework that reduces the costs of a restructuring that the private sector concludes will happen anyway.

In the event that the international community does decide to revisit the concept of a statutory sovereign debt restructuring framework, the considerable progress that was achieved in developing many of the features of the SDRM proposal will provide a useful starting point for discussion and analysis. While not all of the problems relating to the design of the SDRM proposal were resolved, closure was reached on a number of difficult issues. Indeed, provided there is sufficient will to introduce fundamental reform in this area—a significant qualification—there is every reason to believe that a workable and predictable treaty-based restructuring framework (whether created under the IMF’s Articles or elsewhere) could be established.

## Notes

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<sup>1</sup> Adam Smith, *Wealth of Nations*, Book V, Ch. III, at 416 (1776).

<sup>2</sup> Indeed, the IMF's initiative has been described as being "radical" by a number of commentators. See, e.g., Richard N. Cooper, "Chapter 11 for Countries?" 81 *Foreign Affairs* 90, at 90 (2002); Marcus Miller, "Sovereign Debt Restructuring: New Articles, New Contract—or No Change," *International Economy Policy Briefs*, No. PB02-3, at 1 (April 2002), <http://www.iie.com/publications/pb/pb02-3.pdf>; Nouriel Roubini and Brad Setser, "Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions and a Roadmap for Reform," at 12–13 (February 2003), <http://www.worldbank.org/wbi/banking/finsecpolicy/restructuring2004/pdf/roubini-setser.pdf>.

<sup>3</sup> The proposal was publicly launched by Anne Krueger, First Deputy Managing Director of the IMF. Anne Krueger, Speech at the American Enterprise Institute: "International Financial Architecture for 2002: New Approach to Sovereign Debt Restructuring" (November 26, 2001) [hereinafter "New Approach"], <http://www.imf.org/external/np/speeches/external/np/speeches/2001112601.htm>. Additional speeches and publications of Ms. Krueger on this topic include: Anne Krueger, "Address to the Indian Council for Research on International Economic Relations: A New Approach to Sovereign Debt Restructuring" (December 20, 2001), <http://www.imf.org/external/np/speeches/2001/122001.htm>; Anne Krueger, Address to the Economics Society Dinner: "The Evolution of Emerging Market Capital Flows: Why We Need to Look Again at Sovereign Debt Restructuring" (January 21, 2002), <http://www.imf.org/external/np/speeches/2002/012102.htm>; Anne Krueger, Address to the Conference on Sovereign Debt Workouts: "Hopes and Hazards, New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking" (April 1, 2002), <http://www.imf.org/external/np/speeches/2002/04102.htm>; Anne Krueger, Address at the Bretton Woods Committee Annual Meeting: "Sovereign Debt Restructuring and Dispute Resolution" (June 6, 2002), <http://www.imf.org/external/np/speeches/2002/060602.htm>; Anne Krueger, Address at the Latin American Meeting of the Econometric Society: "Preventing and Resolving Financial Crises: The Role of Sovereign Debt Restructuring" (July 26, 2002), <http://www.imf.org/external/np/speeches/2002/072602.htm>; Anne Krueger, Address at the Banco de Mexico's Conference on Macroeconomic Stability, Financial Markets and Economic Development: "Sovereign Debt Restructuring Mechanism: One Year Later" (November 12, 2002), <http://www.imf.org/external/np/speeches/2002/111202.htm>; Anne Krueger, Address at the Annual Meeting of the American Economic Association:

“Sovereign Debt Restructuring, Messy or Messier?” (January 4, 2003), <http://www.imf.org/external/np/speeches/2003/010403.htm>; Anne Krueger, Address at the Harvard University Business School’s Finance Club: “The Need to Improve the Resolution of Financial Crises: An Emerging Consensus?” (March 27, 2003), <http://www.imf.org/external/np/speeches/2003/032703.htm>.

<sup>4</sup> Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism (April 2003) [hereinafter “IMF Managing Director’s Report”], <http://www.imf.org/external/np/omd/2003/040803.htm>.

<sup>5</sup> *Articles of Agreement of the International Monetary Fund*, as amended, Article XXVIII(a) [hereinafter *IMF Articles*], <http://www.imf.org/external/pubs/ft/aa/aa28.htm>. A member’s voting power in the IMF is determined by the size of its quota, which also determines the amount of its financial subscription in the organization and the level of its access to the IMF’s financial resources. A member’s quota is based on the economic size of the member and takes into account the quotas of similar countries.

<sup>6</sup> In his statement at the International Monetary and Financial Committee (IMFC) on April 12, 2003, U.S. Secretary of the Treasury John Snow stated that it is “neither necessary nor feasible to continue working on SDRM.” John W. Snow, U.S. Secretary of the Treasury, Statement at the Meeting of the International Monetary and Financial Committee (April 12, 2003), <http://www.imf.org/external/spring/2003/imfc/state/eng/usa.htm>. For further discussion of the position of the United States on the SDRM, see *infra* the section entitled “Conclusions: Understanding the Resistance.”

<sup>7</sup> For a comprehensive overview of proposals made during the 1980s and 1990s to establish new sovereign debt restructuring frameworks, see Kenneth Rogoff and Jeromin Zettelmeyer, “Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001,” IMF Working Paper No. 02/133 (2002), <http://www.imf.org/external/pubs/ft/wp/2002/wp02133.pdf>.

<sup>8</sup> Alan Beattie, “Bankruptcy Plan Leaves IMF to Fill in the Detail,” *Financial Times* (November 29, 2001), at 15.

<sup>9</sup> In 1995, the IMF’s Legal Department prepared an internal paper entitled “Note on International Adjustment Facility,” which discussed the scope and design of a legal and institutional framework that could be established to restructure the debt of sovereign debtors. For further discussion of this report, see Rogoff and Zettelmeyer, *supra* note 7, at 485–86.

<sup>10</sup> See discussion of Group of Ten (G-10) Deputies Report *infra* note 59 and accompanying text.

<sup>11</sup> See discussion of collective action clauses *infra* text accompanying notes 51–71. At the end of 2001, 59 percent of the value of all outstanding international sovereign bonds was governed by New York law. See IMF, “Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use,” at 5 tbl.1 (June 6, 2002) [hereinafter “Encouraging Greater Use”], <http://www.imf.org/external/np/psi/2002/eng/060602a.pdf>. At that time, only one such bond issuance included the type of “majority restructuring” provision that is generally found in international sovereign bonds governed by English law. See IMF, “The Design and Effectiveness of Collective Action Clauses,” at 7 n.8 (June 6, 2002) [hereinafter “CAC Design”].

<sup>12</sup> Clearly, assessments of sustainability are easier to make with the benefit of hindsight. In an internal study that was completed in October 2003, IMF staff concluded that, by the end of July, “barring some extraordinarily favorable shock, the debt dynamics were clearly unsustainable.” IMF, “Lessons from the Crisis in Argentina,” para. 58 (October 8, 2003), <http://www.imf.org/external/np/pdr/lessons/100803.htm>.

<sup>13</sup> Shortly after the SDRM was launched, Domingo Cavallo, Argentina’s Minister of Economy, acknowledged that a system for sovereign bankruptcy would “undoubtedly be useful.” “When Countries Go Bust,” *The Economist*, (December 6, 2001), at 68.

<sup>14</sup> Based on the information provided by the Argentine authorities, the total value of eligible debt that still remained to be restructured as of December 31, 2003, was US\$82.1 billion. This includes 152 bonds, issued under eight different governing laws and issued in seven currencies. Because much of this debt is held in the retail sector, the number of bondholders is unprecedented. According to Argentina’s secretary of finance, “there are more than 400,000 holders in Italy, around 40,000 in Germany, about 30,000 in Japan, and about 9 million indirectly throughout the Pension funds in Argentina.” See Argentina Secretary of Finance, Ministry of Economy and Production, Investor’s Information Service, <http://www.infoarg.org>.

<sup>15</sup> Michael M. Philips, “Support Builds for Plan to Ease Debt Loads of Developing Nations,” *Wall Street Journal* (September 17, 2002), at A16. As stated by Ms. Krueger in the November 2001 speech that launched the SDRM: “[W]e lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present, the only available mechanism requires the international community to bail out the private creditors.” “New Approach,” *supra* note 3.

<sup>16</sup> The relevant IMF staff papers and related Executive Board documents included the following: IMF, “A New Approach to Sovereign Debt Restructuring: Preliminary Considerations” (November 2001) [hereinafter “Preliminary Considerations”], <http://www.imf.org/external/np/pdr/sdrm/>

2001/113001.pdf; Anne Krueger, “Statement by the First Deputy Managing Director on Sovereign Debt Restructuring Mechanism,” IMF Executive Board Seminar (March 2003), <http://www.imf.org/external/np/pdr/sdrm/2002/030602.pdf>; “Concluding Remarks by the Acting Chair on Sovereign Debt Restructuring Mechanism—Further Reflections and Future Work” (March 2002, BUFF/02/39 EDM 02/3 and 02/4); IMF, “Fund Policy on Lending into Arrears to Private Creditors—Further Considerations of the Good Faith Criterion” (July 30, 2002), <http://www.imf.org/external/pubs/ft/privcred/073002.pdf>; IMF, “Access Policy in Capital Account Crises” (July 29, 2002), <http://www.imf.org/external/external/np/treaccess/2003/pdf/072902.pdf>; IMF, “Communiqué of the International Monetary and Financial Committee of the Board of Governors of the IMF” (September 28, 2002), <http://www.imf.org/external/external/np/sec/pr/2002/pr/0245.htm>; Concluding Remarks by the Chairman: “Sovereign Debt Restructuring Mechanism—Further Considerations” (September 2002, BUFF/02/140, EBM/02/92); IMF, “The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations” (November 2002) [hereinafter “SDRM Design”]; Concluding Remarks by the Acting Chair: “The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations” (January 2003, BUFF/03/1, EBM 02/126); “Sovereign Debt Restructuring Mechanism—Summary of January Workshop” (February 2003, SM/03/67) (unpublished); Note by Staff on Official Bilateral Creditor Claims and SDRM (February 2003) (unpublished); IMF, “Crisis Resolution in the Context of Sovereign Debt Restructuring: A Summary of Considerations” (January 28, 2003); IMF, “Proposed Features of a Sovereign Debt Restructuring Mechanism” (February 12, 2003); “The Acting Chair’s Concluding Remarks—Proposed Features of an SDRM” (March 2003, BUFF/03/1, EBM/03/23); IMF, “Sovereign Debt Restructuring Mechanism—Further Considerations” (August 1, 2002) [hereinafter “SDRM Considerations”]; IMF, “Report of the Managing Director to the International Monetary and Financial Committee on the IMF’s Policy Agenda” (April 11, 2003), <http://www.imf.org/external/np/omd/2003/041103.pdf>; IMF Managing Director’s Report, *supra* note 4.

<sup>17</sup> See, e.g., “A Better Way to Go Bust,” *The Economist* (January 30, 2003), at 64; “Battling over the Bankrupt,” *The Economist* (October 5, 2002), at 70; Martin Wolf, “Debt to the World,” *Financial Times* (April 24, 2002), at 16; “A Better Way to Go Bust,” *The Economist* (April 6, 2002), at 14; Editorial, “Mr. O’Neill Climbs Down,” *Washington Post* (April 4, 2002), at A16; Alan Beattie, “Co-operate or Bust,” *Financial Times* (April 2, 2002), at 13; “Bankrupt U.S. Veto,” *Financial Times* (April 2, 2002); Editorial, “A Question from Argentina,” *Washington Post* (December 11, 2001), at A32, <http://www.washingtonpost.com/wp-dyn/articles/A22945-2001/Dec10.html>; “When Countries Go Bust,” *supra* note 13, at 88; “Ending Bail-Outs,” *Financial Times* (November 29, 2001), at 22.

<sup>18</sup> For example, from January 22 to 23, the IMF hosted a workshop and conference on the SDRM that attracted a broad array of market participants, academics, workout specialists, and judges. See “IMF Consults Widely as It Redefines Proposed Sovereign Debt Plan,” 32 *IMF Survey* 33, at 37 (February 17, 2003) [hereinafter “IMF Consults Widely”], <http://www.imf.org/external/pubs/ft/survey/2003/021703.pdf>. Throughout 2002, IMF staff had consulted informally with many of these participants regarding a number of the SDRM’s design features. *Id.*

<sup>19</sup> A review of the IMF staff papers and the various speeches delivered by Ms. Krueger reveals that the difficulty of securing collective action among creditors with diverse interests was perceived as representing the key weakness in the existing system. However, as the IMF analyzed the nature of collective action problems, it placed increasing emphasis on the problems that arise in the pre-default context. See, e.g., *id.*

<sup>20</sup> Concerns regarding the absence of a transparent and collaborative debt restructuring process are a primary motivation behind the formation of the Emerging Market Creditors Association. See *infra* note 88.

<sup>21</sup> See discussion of IMF financing *infra* notes 72–85 and accompanying text; see also Andy Haldane and Mark Kruger, “The Resolution of International Financial Crises: Private Finance and Public Funds,” Bank of Canada Working Paper 2001–20 (November 2001), at 1. (“[T]he lack of *ex-ante* clarity about the scale of official assistance represents an additional source of risk for borrowers and lenders operating in these markets. It may also serve to delay negotiations between debtors and creditors should repayment problems arise.”)

<sup>22</sup> For a detailed discussion of concerns regarding creditor moral hazard, see discussion *infra* notes 81–82 and accompanying text.

<sup>23</sup> A number of commentators have noted the difficulty of determining when indebtedness is unsustainable in the sovereign context. See Cooper, *supra* note 2, at 92–93; see also Nouriel Roubini, “Do We Need a New Bankruptcy Regime?” 2002(1) *Brookings Papers on Economic Activity*, at 321, 322; Hal S. Scott, “A Bankruptcy Procedure for Sovereign Debtors,” 37 *International Law* 103, at 111 (2003).

<sup>24</sup> Interestingly, in his discussion of the need for some form of sovereign insolvency framework, Jeffrey Sachs has distinguished between two different motivations for a bankruptcy law in the nonsovereign context. While the first motivation is to overcome collective action problems, the second—which only applies to individuals and municipalities—is to provide the debtor with a “fresh start.” Jeffrey D. Sachs, “Resolving the Debt Crisis of Low Income Countries,” 2002(1) *Brookings Papers on Economic Activity*, at 257, [http://www.jubileeusa.org/learn\\_more/BPEA\\_Sachs.pdf](http://www.jubileeusa.org/learn_more/BPEA_Sachs.pdf).

<sup>25</sup> There is a considerable amount of literature regarding the history of the debt crisis in the 1980s. See Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Washington: Brookings Institution, 2003); William Cline, *International Debt: Systemic Risk and Policy Response* (Washington: Institute for International Economics, 1984); C.M. Watson and K.P. Riegling, “History of the Debt Crisis,” in *Current Legal Issues Affecting Central Banks*, Vol. 1, at 67 (Washington: IMF, 1992). With respect to the IMF’s role during the crisis, see James Boughton, *Silent Revolution: The International Monetary Fund 1979–1989* (Washington: IMF, 2001), <http://www.imf.org/external/pubs/ft/history/2001/chapter1.pdf>; see also Sean Hagan, “Sovereign Debtors, Private Creditors, and the IMF,” in Joseph J. Norton, ed., *International Monetary and Financial Law Upon Entering the New Millennium*, at 327–53 (London: BIICL, 2002) [hereinafter Hagan, “Sovereign Debtors”].

<sup>26</sup> For a discussion of the role of bank steering committees during the debt crisis of the 1980s, see Lee C. Buchheit, “Advisory Committee: What’s in a Name,” *International Finance Law Review* (January 1991), at 9; see also Rieffel, *supra* note 25, at 95–132.

<sup>27</sup> It was largely due to this reluctance that the IMF established, in 1989, its policy of “lending-into-arrears,” which enables it to provide financing to countries implementing strong adjustment plans, even in circumstances where they have not yet normalized their relations with private creditors. See Hagan, “Sovereign Debtors,” *supra* note 25, at 338–42; see also *infra* text accompanying notes 89–90.

<sup>28</sup> The most notable example was when Fidelity Union Trust of New Jersey refused to participate in a restructuring agreement that had been reached between Costa Rica and all other members of the syndicate. It sued Costa Rica through the agent, Allied Bank. The ensuing litigation had important implications regarding the development of the doctrine of “comity,” which refers to the deference that the U.S. courts afford to the acts of a foreign sovereign to the extent that they are consistent with the law and policy of the United States. *Allied Bank v. Banco Credito Agrícola de Cartago*, 757 F.2d 516 (2d Cir. 1985) (en banc), cert. dismissed, 473 U.S. 934 (1985). For an analysis of these cases, see Christopher C. Wheeler and Amir Attaran, “Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation,” 39 *Stanford Journal of International Law* 253, at 268–70 (2003).

<sup>29</sup> The distressed debt purchasers that specialize in holding out and enforcing their claims through litigation have gained considerable notoriety over the past 10 years. For a discussion of their tactics and success rate, see Wheeler and Attaran, *supra* note 28. See also Samuel E. Goldman, “Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring,” 5 *UCLA Journal of International Law and Foreign Affairs*



159, at 169–171 (2000–2001); G. Mitu Gulati and Kenneth N. Klee, “Sovereign Piracy,” 56 *Business Law* 635 (2001).

<sup>30</sup> A restrictive theory of sovereign immunity has been adopted under both the U.S. Foreign Sovereign Immunities Act of 1976, 28 U.S.C. §§ 1330, 1602–1611 (FSIA), and the U.K. State Immunity Act of 1978, 10 *Halsbury’s Statutes*, §§ 1–23, at 829–46 (4th ed. 2001 reissue).

<sup>31</sup> 28 U.S.C. § 1605(a)(1).

<sup>32</sup> 28 U.S.C. § 1605(a)(2).

<sup>33</sup> See *Republic of Argentina v. Weltover*, 504 U.S. 607 (1992). The court concluded that “when a Foreign government acts, not as a regulator but in the manner of a private player within it, the Foreign sovereign’s actions are ‘commercial’ within the meaning of the FSIA.” *Id.* at 614.

<sup>34</sup> In the United States, for example, the “act of state” doctrine precludes a court from passing judgment on the legality or validity of public acts of a foreign sovereign to the extent that the sovereign acts within its own territory. However, where bonds issued by the sovereign provide for payment in the United States, the sovereign is considered to have engaged in an activity outside its territory and the act of state doctrine does not apply. See *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d Cir. 1985). Another defense that has become increasingly unavailable is that of champerty, which prohibits litigating a claim that was acquired for the exclusive purpose of filing a lawsuit. While this doctrine is recognized in both the United States and England, recent decisions in both jurisdictions demonstrate the desire of the courts to interpret this doctrine very narrowly. See *Elliott Associates, L.P. v. Banco de la Nacion*, 194 F.3d 363 (2d Cir. 1999); *Camdex International Limited v. Bank of Zambia* [1996] QB 22.

<sup>35</sup> For a discussion of the difficulties encountered in executing judgments under the FSIA, see Richard W. Cutler, “Executing Judgments Under FSIA: Winning Isn’t Everything,” *New York Law Journal* (August 17, 1995), at 1.

<sup>36</sup> See Philip R. Wood, *Project Finance, Subordinated Debt, and State Loans*, at 104 (Sweet & Maxwell, 1995). Moreover, to the extent that a statute allows seizure of the sovereign’s property in aid of executive, it would be possible for the government—with the assistance of the legislature—to repeal such legislation.

<sup>37</sup> 28 U.S.C. § 1610(a).

<sup>38</sup> See, e.g., *Connecticut Bank of Commerce v. Republic of Congo*, 309 F.3d 240 (5th Cir. 2002).

<sup>39</sup> See, e.g., *National City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611 (1983).

<sup>40</sup> *LNC Investments, Inc. v. Republic of Nicaragua*, 115 F. Supp. 2d 358 (S.D.N.Y. 2000). For a comprehensive analysis of the treatment of central banks under the FSIA, see Paul L. Lee, “Central Banks and Sovereign Immunity,” 41 *Columbia Journal of Transnational Law* 327 (2003); E.T. Patrikis, “Foreign Central Bank Property: Immunity from Attachment in the United States,” 1982 *University of Illinois Law Review* 265 (1982).

<sup>41</sup> See Elliott Assoc. No. 2000QR92 (Court of Appeals of Brussels, 8th Chamber, September 26, 2000). Elliott had acquired in the secondary market US\$20.7 million face amount of commercial bank loans that had been guaranteed by the Republic of Peru. Unlike most other creditors, Elliott did not participate in the restructuring of Peru’s debt, which involved an exchange of bank loans for Brady bonds. Instead, Elliott filed suit in New York for a recovery of the full face amount of the debt, plus accumulated interest, and obtained a judgment against Peru in the amount of US\$56 million. Armed with this judgment, it then sought injunctive relief in several jurisdictions designed to prevent Peru from making a scheduled interest payment to the holders of the Brady bonds unless a payment was made to Elliott at least proportionate to the payments being made to the Brady bondholders. In addition to obtaining an ex parte temporary restraining order preventing Peru’s fiscal agent from making the interest payment, it obtained an ex parte order from a Brussels court preventing Euroclear from accepting payments from Peru that were intended to be distributed to the holders of its Brady bonds. Before the ex parte restraining order could be challenged by Peru or by Euroclear, Peru settled with Elliot, perhaps in part in order to avoid risking a payment default on its Brady bonds.

<sup>42</sup> For a discussion of the reasons why the *pari passu* provision cannot be reasonably interpreted as limiting payments, see Lee Buchheit and Jeremiah Pam, “The Pari Passu Clause in Sovereign Debt Instruments,” 53 *Emory Law Journal* 763 (2004); see also Gulati and Klee, *supra* note 29; Phillip R. Wood, “Pari Passu Clauses—What Do They Mean?” 18 *Butterworths Journal of International Banking and Finance Law* 371 (2003).

<sup>43</sup> A *pari passu* provision typically provides as follows: “The notes rank, and will rank, *pari passu* in right of payment with all other present and future unsecured and unsubordinated External Indebtedness of the Issuer.”

<sup>44</sup> See generally Buchheit and Pam, *supra* note 42.

<sup>45</sup> *Memorandum of Law of Amicus Curiae The New York Clearing House Associations L.L.C. in Support of Motion Pursuant to CPLR Section 5340 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors*, January 12, 2004; *Statement of Interest of the United States*,

January 12, 2004; *Memorandum of Law of Amicus Curiae Federal Reserve Bank of New York in Support of Motion Pursuant to CPLR Section 5340 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors*, January 12, 2004.

<sup>46</sup> See, e.g., *Memorandum of Law of the Republic of Argentina in Support of Its Motion Pursuant to CPLR 5240 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors*, *EM Ltd v. The Republic of Argentina*, No. CV 2507 (TPG). Among the authorities cited in the brief is Section 18 of the Restatement (Second) of Judgments (1982), which reads, in part: “When a valid and final judgment is rendered in favor of the plaintiff ... the plaintiff cannot therefore maintain an action on the original claim or any part thereof, although he may be able to maintain an action upon the judgment.”

<sup>47</sup> Court of Appeals of Brussels, No. 2003KR334, at 13. The decision of the Court of Appeals is presently on appeal to Belgium’s Supreme Court of Justice. Belgium recently amended Article 9 of the law that implements European Directive 9826EC for the purpose of ensuring that future court orders do not prevent Euroclear from receiving and channeling payments on account of bondholders. See Belgian Law 1119204, art. 15.

<sup>48</sup> See *Red Mountain Finance Inc. v. Democratic Republic of Congo and National Bank of Congo*, Case No. CV 00-0164 (C.D. Cal. May 21, 2001).

<sup>49</sup> *Id.* Transcript of May 29 hearing at 6–7. Indeed, the judge apparently deleted by hand the introductory language requested by Red Mountain that stated that “plaintiff’s motion ... for Specific Performance of Covenants in Aid of Execution is granted.” *Id.*

<sup>50</sup> One of the striking features of the order is that it does not appear to have any geographical limitation. Under the terms of the injunction, even payments made by the Democratic Republic of the Congo to creditors outside the United States from funds not subject to execution would have violated the order unless proportionate payments were made to Red Mountain. The extraterritorial reach of the order raises the question of whether it is consistent with the provisions of the FSIA, which only allows for execution with respect to “property in the United States of a Foreign state ... used for a commercial activity in the United States.” 28 U.S.C. § 1610(a); see, e.g., *Fidelity Partners, Inc. v. First Trust Co. of New York*, 58 F. Supp. 2d 52, 54 (S.D.N.Y. 1997), *remanded for consideration of mootness*, 142 F.3d 560 (2d Cir. 1998), *prior decision adhered to on remand*, 58 F. Supp. 2d 55 (S.D.N.Y. 1999), *aff’d*, 216 F.3d 1072 (2d Cir. 2000); *Fidelity Partners, Inc. v. Philippine Export and Foreign Loan Guarantee Corp.*, 921 F. Supp. 1113 (S.D.N.Y. 1996); *Philippine Export and Foreign Loan Guarantee Corp. v. Chuidian*, 267 Cal. Rptr. 457 (California Court of Appeals 1990).

<sup>51</sup> See Encouraging Greater Use, *supra* note 11. As of late December 2001, bonds governed by New York law and English law represented 59 percent and 24 percent, respectively, of the total value of international sovereign bonds outstanding. For a comprehensive analysis of the origins of collective action clauses, see Lee Buchheit and G. Mitu Gulati, “Sovereign Bonds and the Collective Will,” 51 *Emory Law Journal* 1317 (2002). For analysis of the various features of collective action clauses, see “CAC Design,” *supra* note 11.

<sup>52</sup> See “CAC Design,” *supra* note 11, at 5–10; G-10 Working Group, Report of the G-10 Working Group on Contractual Clauses 3–4 (September 26, 2002) [hereinafter “G-10 Working Group Report”], <http://www.bis.org/publ/gten08.pdf>; Buchheit and Gulati, *supra* note 51, at 1324–26.

<sup>53</sup> Their absence from bonds governed by New York law does not arise from a legal constraint. The U.S. Trust Indenture Act (TIA), enacted in 1939, prohibits any impairment of a bondholder’s right to receive payments due (or to recover the missed payments) without its consent, except that it allows a majority of bondholders with 75 percent of outstanding principal to postpone interest payments for up to three years. This limitation does not apply to sovereign bonds. For a general discussion of the motivations of the TIA, see Buchheit and Gulati, *supra* note 51, at 1326–30.

<sup>54</sup> On February 14, 2000, the German federal government issued a statement on the acceptability of including collective action clauses in sovereign bond issues subject to German law. However, this statement did not affect market practice, and German law firms have generally been reluctant to issue legal opinions confirming the validity of such provisions. As a means of further promoting the inclusion of the clauses in sovereign bonds, legislation is being considered that would confirm the consistency of these provisions with German law. See “CAC Design,” *supra* note 11, at 8; G-10 Working Group Report, *supra* note 52, at 4 n.3; see also, IMF, “Progress Report to the International Monetary and Financial Committee on Crisis Resolution,” at 5 n.9 (April 20, 2004), <http://www.imf.org/external/np/pdr/cr2004/eng/042004.pdf>.

<sup>55</sup> While bonds governed by New York law contain a special de-acceleration provision, bonds governed by English law normally achieve deceleration by using the majority restructuring provision to amend the maturity date. See “CAC Design,” *supra* note 11, at 11–12.

<sup>56</sup> While a trustee may also initiate proceedings at its own discretion, it will normally not do so because of the costs and the risks involved. For a further discussion of the trust deed structure, see *id.* at 12–13.

<sup>57</sup> For a further discussion of the use of the majority restructuring provisions in the case of Ukraine, see IMF, “Involving the Private Sector in the

Resolution of Financial Crises—Restructuring International Sovereign Bonds,” at 6 box 2.3 (February 5, 2001) [hereinafter “Involving the Private Sector”], <http://www.imf.org/external/pubs/ft/series/03IPS/pdf>. Interestingly, although Pakistan had collective action clauses in its bonds, it decided not to use them when it restructured its debt in 2000. *See id.* at 5 box 2.2.

<sup>58</sup> For a discussion of the successful Uruguay exchange, see Ben Maiden, “Uruguay Faces Up to Challenges of Emerging Market Debt,” *International Financial Law Review* (2003).

<sup>59</sup> The call for the inclusion of collective action clauses in international sovereign bonds was contained in a report of the G-10 Deputies Working Group. G-10 Deputies Working Group, “The Resolution of Sovereign Liquidity Crises” (May 1996) [hereinafter “G-10 Deputies Report”], <http://www.bis.org/pub/lgtten/03.htm>. The G-10 Deputies Report notes that certain contractual provisions, if broadly contained in international debt contracts, could help to facilitate debt holders’ decision making and hence the resolution of a sovereign liquidity crisis. Other benefits include the fostering of dialogue and consultation between the sovereign debtor and its creditors and the reduction of the ability of a small number of dissident creditors to disrupt, delay, or prevent arrangements supporting a credible adjustment program that are acceptable to the vast majority of the interested parties. *Id.* at 15. But the G-10 Deputies Report emphasized that the cooperation between sovereign borrowers and their creditors needs to be a market-led process if it is to be successful. *Id.* at 1.

<sup>60</sup> At the end of 2001, 59 percent of the value of all outstanding international sovereign bonds were governed by New York law. *See* “Encouraging Greater Use,” *supra* note 11, at 5 tbl.1. At that time one such bond issuance included the type of “majority restructuring” provision that is generally found in international sovereign bonds governed by English law. *See* “CAC Design,” *supra* note 11, at 7 n.8.

<sup>61</sup> The process started with Mexico, which included majority restructuring provisions in the bonds that it issued in early 2003. Since then, the following additional countries have issued bonds governed by New York law that include majority restructuring provisions: Belize, Brazil, Colombia, Costa Rica, Guatemala, Indonesia, Italy, Korea, Lebanon, Panama, Peru, Philippines, Poland, South Africa, Turkey, Uruguay, and Venezuela (as of June 30, 2004).

<sup>62</sup> The relationship between collective action clauses and the SDRM, at least from the perspective of market participants, was clearly outlined by Adam Lerrick and Allan H. Meltzer, “Sovereign Default: The Private Sector Can Resolve Bankruptcy Without a Formal Court,” *Quarterly International Economic Report* (April 2002), at 2 (“With bailouts ruled out, the private sector is confronted with a choice: accept regulation or find its own solution

to make restructuring work.”). See also Barry Eichengreen et al., “Crisis Resolution: Next Steps,” IMF Working Paper No. 03/196 (October 2003) (pointing out that the Institute of International Finance’s embrace of collective action clauses would never have happened in the absence of the SDRM initiative), <http://www.imf.org/external/pubs/ft/wp2003/wp/03196.pdf>.

<sup>63</sup> While this limitation was identified by the IMF in its work on the SDRM, it has also been specifically recognized as a critical issue by others. See Patrick Bolton and David A. Skeel, Jr., “Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?” in this volume of *Current Developments in Monetary and Financial Law*, pp. 307. See also Scott, *supra* note 23, at 122; Patrick Bolton, “Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World,” 50 *IMF Staff Papers* 41 (2003), <http://www.imf.org/External/Pubs/FT/staffp/2002/00-00/pdf/bolton.pdf>. In one academic study, empirical evidence was presented to suggest that, where there are a large number of different issuances, the problem that this creates may affect the price of the bonds, at least with respect to sovereigns with poor credit and limited market access. See Eichengreen et al., *supra* note 62, at 27–31.

<sup>64</sup> See “CAC Design,” *supra* note 11, at 13.

<sup>65</sup> “Involving the Private Sector,” *supra* note 57, at 6.

<sup>66</sup> See, e.g., John B. Taylor, “Sovereign Debt Restructuring: A U.S. Perspective,” Remarks at the Institute for International Economics (April 2, 2002), <http://www.ustreas.gov/press/releases/po/2056.htm>. “There is no reason to restrict the scope of these clauses to bonded debt. It would be appropriate, for example, to include such clauses in bank debt along with bonded debt.” *Id.*

<sup>67</sup> See Lerrick and Meltzer, *supra* note 62, at 3:

To be truly effective, [majority action] clauses should not be applied issue by issue but across all debt of the same priority rank. Otherwise, a maverick investor, who accumulates a blocking minority position in a single small issue, can attempt to hold hostage the entire restructuring process. The voting provisions should be based upon a super-majority of all creditors of the same priority, regardless of the instrument held—bond, loan or trade credit—as long as the treatment of all individual groups of claims is non-discriminatory.

<sup>68</sup> See B. Maiden, *supra* note 58.

<sup>69</sup> See, e.g., *Director General of Fair Trading v. First National Bank plc.* [2001] 3 W.L.R. 1297 (“It is trite law in England that once a judgment is obtained under a loan agreement for a principal sum and judgment is

entered, the contract merges in the judgment and the principal becomes owed under the judgment and not under the contract”).

<sup>70</sup> See *supra* text accompanying note 11.

<sup>71</sup> Even among those that have argued that the doctrine of merger precludes the invocation of the *pari passu* provision, there is a recognition that certain provisions relating to enforcement survive the entry of judgment. See, e.g., *Memorandum of Law of the Republic of Argentina in Support of Its Motion Pursuant to CPLR 5240 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors, EM Ltd. v. The Republic of Argentina*, No. CV 2507 (TPG).

<sup>72</sup> For emerging market economies that wish to access the capital markets, it has also been emphasized that the reputational costs arising from a restructuring will also weigh heavily on the decision maker. See Bolton and Skeel, *supra* note 63, at 309.

<sup>73</sup> While some have focused exclusively on the problems arising from the availability of IMF financing, others have recognized that improvements in the system also require reform of the legal framework—whether through contract or otherwise—that guides the restructuring process. See generally Eichengreen et al., *supra* note 62, at 5; Scott, *supra* note 23; Hal S. Scott, “How Would a New Bankruptcy Regime Help?” 2002(1) *Brookings Papers on Economic Activity*, at 334 [hereinafter Scott, “Bankruptcy Regime”]. See Bolton, *supra* note 63; Bolton and Skeel, *supra* note 63; Lerrick and Meltzer, *supra* note 62. The need for reform on both fronts was also recognized by the United States relatively early during the reform discussions. See Taylor, *supra* note 66.

<sup>74</sup> *IMF Articles*, *supra* note 5, Article I.

<sup>75</sup> *Id.* Article V, Section 3(a).

<sup>76</sup> *Id.* Although the maturity structure for IMF obligations varies, the standard period is three to five years. *Id.* Article V, Section 7(d).

<sup>77</sup> The Guidelines on Conditionality set forth the general principles that the IMF applies when considering both (a) the type of economic reform programs it will support with its resources and (b) the types of conditions it will formulate for purposes of ensuring that its resources actually support the effective implementation of these programs. IMF, *Selected Decisions and Selected Documents of the International Monetary Fund*, 29th Issue (IMF, 2004), at 223–31 [hereinafter *Selected Decisions*], <http://www.imf.org/external/pubs/ft/sd/index.asp>.

<sup>78</sup> Exceptional access is defined as access by a member to the IMF’s general resources, under any type of financing, in excess of an annual limit of 100 percent of quota or a cumulative limit (net of scheduled repurchases) of

300 percent of a member's quota. The existing criteria used for purposes of determining whether a member qualifies for exceptional access are discussed *infra* note 101.

<sup>79</sup> In the event that the overindebtedness is in the banking or enterprise sector, the objective will be to avoid the imposition of capital controls.

<sup>80</sup> Haldane and Kruger, *supra* note 21, at 1 (“And the lack of *ex-ante* clarity about the scale of official assistance represents an additional source of risk for borrowers and lenders operating in these markets. It may also serve to delay negotiations between debtors and creditors should repayment problems arise.”). At a later stage in the paper, the argument is posed as follows:

Too much discretion regarding official actions leads to confusion among debtors and creditors and time-consistency problems among policymakers. Greater clarity about the scale of official financing would help to condition the actions and expectations of debtors and creditors about the roles they are expected to play in resolving crises.

*Id.* at 3. It has also been observed that the expectation of future IMF financing was a key reason the proposed exchange offer made by Russia in 1998 was unsuccessful. *See* Bolton, *supra* note 63, at 31.

<sup>81</sup> The existence of creditor moral hazard is cited by a variety of legal and economic commentators as a principal motivation for either stricter limits on IMF financing or a more robust legal framework for the restructuring of sovereign debt. *See generally* Rogoff and Zettelmeyer, *supra* note 7. *See* Steven L. Schwarcz, “Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach,” 85 *Cornell Law Review* 956, at 962 (2001); Jeremy Bulow and Kenneth Rogoff, “Sovereign Debt: Is to Forgive to Forget?” 79 *American Economic Review* 43 (1989), <http://ideas.repec.org/a/aea/aecrev/v79y1989i1p43-50.html>; Adam Lerrick and Allan H. Meltzer, “Blueprint for an International Lender of Last Resort,” 50 *Journal of Monetary Economy*, at 289–308 (2003); Scott, “Bankruptcy Regime,” *supra* note 73; Miller, *supra* note 2, at 7; Bolton and Skeel, *supra* note 63. Some have gone so far as to argue that the moral hazard problems created by IMF financing can only be remedied by the abolition of the IMF itself. *See* Anna Schwartz, “Time to Terminate the ESF and the IMF,” Foreign Policy Briefing No. 48, Cato Institute (1998), <http://www.cato.org/pubs/fpbriefs/fpb-048.pdf>.

<sup>82</sup> Among those that have identified creditor moral hazard as a major consequence of large IMF financing packages, there are those who also point out that such financing also reduces the discipline on a sovereign debtor's own economic policies. *See, e.g.,* Scott, *supra* note 23, at 113.



[T]he issue is not whether creditors have paid a price for making bad loans, but whether the price has been commensurate with the risk. IMF and official support have sheltered creditors from paying the full price of the risks they have assumed. The result has been that they have been more willing to make loans than they would have otherwise have been, and that debtor countries have incurred more debt or engaged in less prudent fiscal and monetary policies than they otherwise would have had they known no official support was forthcoming.

*Id.* at 114–15.

<sup>83</sup> See Steven L. Schwarcz, “Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach,” 85 *Cornell Law Review* 956, at 962 (2001) (“Notwithstanding the lack of empirical evidence of the extent, if any, to which the moral hazard risk actually influences the behavior of States or their creditors, the potential for moral hazard figures prominently in the media debate . . .”).

<sup>84</sup> Because the IMF’s resources are limited, the notion that the IMF can perform a true lender of last resort function is an inaccurate one. Indeed, the problems arising from the growing demands on the IMF’s finite resources have been identified by a number of commentators as an important motivation for reform. See, e.g., Cooper, *supra* note 2, at 92–93; Hagan, “Sovereign Debtors,” *supra* note 25, at 337–42; Bolton, *supra* note 63, at 3.

<sup>85</sup> Stanley Fischer, “The International Financial System: Crises and Reform” (October 29–31, 2001), <http://www.iie.com/fischer/pdf/Fischer178.pdf>.

<sup>86</sup> The approach relied upon by Ecuador to restructure its Brady bonds and Eurobonds from 1999 to 2000 was the first case that generated considerable criticism in that regard. After Ecuador defaulted on its external bonds, the authorities refused to engage in negotiations with bondholders. Although the authorities established a so-called Consultative Group of eight institutional investors with large exposure, the authorities did not provide them with any confidential information or, more generally, engage in the type of dialogue that had generally been commonplace during the restructurings of the 1980s, where the debtor was engaged in a relatively structured negotiating process through the bank steering committees. For a discussion of investors’ concerns regarding the process that was relied upon by Ecuador to restructure its bonds, see F. Salmon and J. Gallardo, “The Buy Side Starts to Bite Back,” *Euromoney* (April 2001), at 46.

<sup>87</sup> For a discussion of the broader implications of the strategy relied upon by Ecuador, see “Involving the Private Sector,” *supra* note 57.

<sup>88</sup> Largely in reaction to the restructuring strategy followed by Ecuador, those that specialize in purchasing and holding emerging market debt formed

their own association, called the Emerging Market Creditors Association (EMCA). One of the stated objectives of EMCA is “[e]stablishing a general framework for debt restructurings that involves bondholders and ensures the fair treatment of their claims.” See Emerging Market Creditors Association, Mission Statement, <http://www.emcreditors.com>. EMCA’s establishment represented an effort by buy-side investors to ensure that the interests of the private sector in discussions regarding reform of the international financial architecture were not represented exclusively by the sell-side, i.e., by those institutions that intermediate but do not invest in emerging market debt. In one publication, the founders of EMCA suggested that, in the absence of a more equitable and transparent restructuring process, there would be far less interest in emerging market debt as an asset class:

This is fundamental: That private sector willingness to provide capital in the future will depend on the *character* of interaction between official actors, debtors and bondholders, as well as the specific outcome. Players who believe themselves to have been “hard done by” tend not to stay in the game, they tend to leave the field after extracting whatever near term justice they can. Players who lose, but believe in the game, tend to return to the field.

Bond Holders Working Group, “Bondholder Roles in Sovereign Crisis Management and Prevention,” at 7–8, [http://emcreditors.com/pdf/bondholder\\_management\\_prevention.pdf](http://emcreditors.com/pdf/bondholder_management_prevention.pdf).

<sup>89</sup> See IMF, *supra* note 77, at 305–11. For a discussion of the origins and recent application of the IMF’s lending into arrears policy, see Hagan, “Sovereign Debtors,” *supra* note 25, at 338–42.

<sup>90</sup> See “Involving the Private Sector,” *supra* note 57, at 9–10.

<sup>91</sup> For a description of the Paris Club process, see Eichengreen et al., *supra* note 62, annex 4; see also Rieffel, *supra* note 25, at 56–95.

<sup>92</sup> The “Proposed Features” are attached to the “IMF Managing Director’s Report,” *supra* note 4.

<sup>93</sup> The interlocking relationship between the various elements of the crisis resolution framework is well articulated by Eichengreen, albeit in the context of collective action clauses:

The fundamental question for participants in this debate is whether new procedures for resolving sovereign debt crises will significantly enhance the efficiency and stability of international financial markets and the growth and stability of the developing countries that depend on those markets. Our view is that while these provisions will make a difference, they are only one among many needed improvements. The case for them is strongest if their

addition to loan agreements is viewed as one of a number of interdependent changes in the international financial architecture, none of which is feasible in the absence of the others but which together promise to make the world a significantly safer place.

Eichengreen et al., *supra* note 62, at 37.

<sup>94</sup> See IMF, “Proposed Features of a Sovereign Debt Restructuring Mechanism,” para. 11 (February 12, 2003) [hereinafter “Proposed Features”], <http://www.imf.org/external/np/omd/2003/040803.htm>.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* para. 3(b).

<sup>98</sup> *Id.* para. 5.

<sup>99</sup> *Id.* para. 8.

<sup>100</sup> *Id.* para. 3(d)(vi).

<sup>101</sup> In parallel with the development of the SDRM, the IMF has also sought to provide further clarity to its access policy. While an assessment of debt sustainability remains central to the determination as to whether exceptional access will be provided, greater efforts have been made to strengthen the methodology that is used when making these assessments. Moreover, when determining whether a member should be granted exceptional access, the IMF has decided to pay greater attention to the implications of such access on the liquidity position of the IMF. In 2002, the IMF adopted a policy that provides guidance as to the circumstances when it will grant exceptional access in capital account crises. The policy requires that the following criteria be met:

- (i) The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within normal limits;
- (ii) A rigorous and systemic analysis indicates that there is a high probability that debt will remain sustainable;
- (iii) The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund’s financing would provide a bridge; and
- (iv) The policy program of the member country provides a reasonably strong prospect of success, including not only a member’s adjustment plans but also its institutional and political capacity to deliver that adjustment.

IMF, *supra* note 77, at 322–23. When considering exceptional access, it has also been agreed that the relevant staff paper would include an assessment of the risks to the IMF arising from the exposure and its effect on liquidity. *Id.* at 324.

<sup>102</sup> The notion that a more orderly and less costly restructuring framework would reduce the pressure on the IMF to continue financing in marginal situations has been recognized by a number of economic and legal commentators. *See, e.g.*, “G-30 Working Group Report, Key Issues in Sovereign Debt Restructuring” (2002) [hereinafter “G-30 Working Group Report”]; Eichengreen et al., *supra* note 62, at 5; Scott, “Bankruptcy Regime,” *supra* note 73, at 335. Scott appropriately recognized that the relationship between the SDRM and IMF financing was “indirect”: “The idea is that pressure for IMF lending would be lessened if the SDRM offered a mechanism by which a troubled sovereign debtor and its creditors could reach an agreement to reduce the sovereign’s debt.” *Id.*; *see also* Eichengreen et al., *supra* note 62, at 1. Kenneth Rogoff, the IMF’s former Chief Economist, noted that the strengthened ability of the IMF to resist pressure for financing unsustainable debt would be one of the “by-products of the SDRM.” Kenneth Rogoff, “Emerging Market Debt: What Is the Problem?” Speech at the IMF Sovereign Debt Restructuring Conference (January 22, 2003), <http://www.imf.org/external/np/speeches/2003/012203a.htm>.

<sup>103</sup> Under U.S. bankruptcy law, the votes for a plan may be solicited and obtained prior to the commencement of reorganization proceedings. 11 U.S.C. § 1126. For a discussion of prepackaged and prenegotiated plans under Chapter 11, see Stephen H. Case and Mitchell A. Harwood, “Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations,” 1991 *Annual Survey of American Law* 75 (1991).

<sup>104</sup> The idea that a more predictable framework would enhance the quality of emerging market debt as an asset class is recognized in G-30 Working Group Report, *supra* note 102, at 1–2, 4. There are others, however, who took the view that the SDRM would have reduced the flows to emerging market economies and that this reduction would have been beneficial to the overall system. *See, e.g.*, Cooper, *supra* note 2, at 94.

<sup>105</sup> As noted by a number of commentators, the goal was to reduce the cost of restructuring for all involved while not actually encouraging defaults. *See, e.g.*, Roubini, *supra* note 23, at 323. Some observers have argued that a key element that reduces the risk of debtor moral hazard in the sovereign context—particularly for emerging market sovereigns wishing to regain or maintain access to the capital markets—is the reputational cost of default. *See, e.g.*, Bolton and Skeel, *supra* note 63, at 309.

<sup>106</sup> Article XXVIII of the IMF's Articles provide that an amendment will enter into force for all members once it has been accepted by three-fifths of the members, holding 85 percent of the total voting power, *IMF Articles*, *supra* note 5, Article XXVIII(a).

<sup>107</sup> *IMF Articles*, *supra* note 5, Article XXXI, Section 2(a).

<sup>108</sup> See Editorial, "A Question from Argentina," *Washington Post* (December 11, 2001), at A32 ("Mr. O'Neill needs to decide whether Congress can be talked into ceding sovereignty to an international bankruptcy court. If that looks impossible, it would be better to bury the whole subject quickly."); "Battling over the Bankrupt," *supra* note 17, at 70.

<sup>109</sup> For a comprehensive discussion of the relevance of corporate reorganization legislation to the restructuring of sovereign debt, see Bolton, *supra* note 63; Bolton and Skeel, *supra* note 63; Schwarcz, *supra* note 83; Scott, *supra* note 23; Michelle J. White, "Sovereigns in Distress: Do They Need Bankruptcy?" 2002(1) *Brookings Papers on Economic Activity*, at 287–319, [http://econ.ucsd.edu/~miwhite/BPEA\\_White.pdf](http://econ.ucsd.edu/~miwhite/BPEA_White.pdf).

<sup>110</sup> While some of the proposals were designed by economists, others were formulated by the legal profession. The various proposals are reviewed in Rogoff and Zettelmeyer, *supra* note 7. Perhaps the most comprehensive and detailed proposal, which was published shortly before the SDRM was launched in November 2001, is that of Professor Steven Schwarcz. See Schwarcz, *supra* note 83.

<sup>111</sup> While insolvency laws vary considerably among countries, over the past several years it has become increasingly possible to identify emerging "standards" and best practices in this area. Most important, the United Nations Commission on International Trade Law (UNCITRAL) recently adopted the *Legislative Guide on Insolvency Law*, which provides detailed analysis and recommendations on all aspects of the design of an insolvency law. UNCITRAL Legislative Guide on Domestic Insolvency Law (October 5, 2004) [hereinafter *UNCITRAL Legislative Guide*], at <http://www.uncitral.org/english/texts/insolven/provisfinal.pdf>. This work builds upon work that has been done by a variety of international organizations, including that of the IMF and the World Bank. See IMF, *Orderly and Effective Insolvency Procedures—Key Issues* (Washington: IMF, 1999); World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (April 2001), <http://siteresources.worldbank.org/GILD/PrinciplesAndGuidelines/20162797/Principles%20and%20Guidelines%20for%20Effective%20Insolvency%20and%20Creditor%20Rights%20Systems.pdf>.

<sup>112</sup> See *UNCITRAL Legislative Guide*, *supra* note 111, at 213, 218; IMF, *supra* note 111, at 59–60.

<sup>113</sup> See *UNCITRAL Legislative Guide*, *supra* note 111, at 197–212, 216; IMF, *supra* note 111, at 64–69. Some commentators have argued, however, that it could be feasible to construct the equivalent of a liquidation benchmark for a sovereign state. See Scott, *supra* note 23, at 130.

<sup>114</sup> In recognition of these limitations, a number of commentators have pointed to the potential relevance of Chapter 9 of the U.S. Bankruptcy law, which governs the debts of municipal governments, to sovereign states. See 11 U.S.C. § 900 *et seq.* Commentators who have advocated the use of Chapter 9 in this context include Kunibert Raffer, “Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face,” 18 *World Development* 301 (1990). See also John Chun, “Post-Modern Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?” 64 *Fordham Law Review* 2647 (1996). A number of the features of Chapter 9 that are of potential relevance to the sovereign context are (i) only the debtor can initiate proceedings; (ii) the bankruptcy court may not interfere with any of the debtor’s political or governmental powers; and (iii) a Chapter 9 proceeding may not be converted into a liquidation. At the same time, however, an important limitation to the Chapter 9 analogy is that municipalities are not sovereign. Indeed, Chapter 9 acknowledges the power of the state within which the municipality exists to continue to control the exercise of the municipality’s powers, including expenditures. For this reason and others, a number of commentators and scholars have been somewhat skeptical of the Chapter 9 analogy. See White, *supra* note 109, at 9–11; Schwarcz, *supra* note 83, at 980–81.

<sup>115</sup> See, e.g., Andrei Shleifer, “Will the Sovereign Debt Market Survive?” 3–4, National Bureau of Economic Research Working Paper No. 9493 (2003); Sergio Galvis, “Sovereign Debt Restructurings—The Market Knows Best,” 6 *International Finance* 145, at 150 (2003). Indeed, these differences were part of the reason why the official sector declined to seriously consider a statutory framework on earlier occasions. See G-10 Working Group Report, *supra* note 52, at 4; Eichengreen et al., *supra* note 62, at 15; White, *supra* note 109, at 24.

<sup>116</sup> In his proposal to establish a statutory framework for sovereign debtors, Professor Schwarcz is also sensitive to the need to design a framework that takes into consideration the unique features of the sovereign state and, in that context, does not create debtor moral hazard. See Schwarcz, *supra* note 83. Others have also taken issue with the assumption that a statutory framework will necessarily create moral hazard. See Celeste Boeri, “How to Solve Argentina’s Debt Crisis: Will the IMF’s Plan Work?” 4 *Chicago Journal of International Law* 245 (2003).

<sup>117</sup> See relevant discussion of stay on creditor enforcement *infra* in the section entitled “The Stay on Creditor Enforcement.”

<sup>118</sup> *IMF Articles*, *supra* note 5, Article XXVIII(a).

<sup>119</sup> The potential conflicts that would arise if the IMF's Executive Board were to perform a dispute resolution function were recognized at the outset. *See* Preliminary Considerations, *supra* note 16, at 16–17. Commentators have reached similar conclusions. *See, e.g.*, Eichengreen et al., *supra* note 62 at 44; Michael T. Hilgers, “Debtor-States and an International Bankruptcy Court: The IMF Creditor Problem,” 4 *Chicago Journal of International Law* 257, at 263 (2003).

<sup>120</sup> “The IMF is so politicized in its decision making that it is impossible that administrating a bankruptcy procedure would be any less politicized than administering general funds.” Suara Merdeka, “Wall Street Gives IMF Bankruptcy Plan Cool Reception,” *Reuters* (December 1, 2001) (quoting Kasper Bartholdy of Credit Suisse First Boston), at <http://www.suara-merdeka.com/harian/0112/01eng7.htm>; *see* Bolton, *supra* note 63, at 38; Bolton and Skeel, *supra* note 63, at 351; *see also* Eichengreen et al., *supra* note 62, at 44.

<sup>121</sup> *See* discussion of Dispute Resolution Forum *infra* in the section entitled “Dispute Resolution Forum.”

<sup>122</sup> “Proposed Features,” *supra* note 94, para. 2.

<sup>123</sup> *See* discussion of Dispute Resolution Forum *infra* in the section entitled “Dispute Resolution Forum.”

<sup>124</sup> *See UNCITRAL Legislative Guide*, *supra* note 111, at 199–212, 215–16; IMF, *supra* note 111, at 64–69.

<sup>125</sup> In some countries, including the United States, a plan can be approved over the objections of a class that is affected by the plan. *See, e.g.*, 11 U.S.C. § 1129(b). The authority of the court to approve a plan in these circumstances is often referred to as “cram-down” authority. Where the court exercises such authority, the law will often require that certain protections be provided to the dissenting class to avoid discrimination between different classes of creditors, taking into account their relative priority in liquidation. In the United States, for example, the court will apply what is referred to as the “absolute priority rule.” This standard of relative protection among different classes of creditors should be distinguished from the absolute protection that is afforded to individual dissenting creditors within a class that has approved a plan. The latter standard often requires that the dissenting creditor receive at least what it would have received in liquidation. *See UNCITRAL Legislative Guide*, *supra* note 111, at 216–17 (Recommendation 151); *see also* IMF, *supra* note 111, at 64–69. Of course, one of the difficulties of applying “cram down” in the sovereign context is that there is no liquidation law that provides a basis for determining the relative priority of claims. This is a key reason why it was not pursued under

the SDRM. Another reason, stated above, is that would require greater reliance on the Dispute Resolution Forum. A number of commentators have also pointed to the difficulty of introducing a cram-down rule in the sovereign context. *See* Schwarcz, *supra* note 83, at 1006–1008; Scott, “Bankruptcy Regime,” *supra* note 73, at 339.

<sup>126</sup> *See UNCITRAL Legislative Guide, supra* note 111, at 199–212; IMF, *supra* note 111, at 64–69.

<sup>127</sup> The absence of a clear priority structure for sovereign debt and the implications that this absence has on the restructuring process is analyzed by Anna Gelpern, “Building a Better Seating Chart for Sovereign Debt Restructurings,” 53 *Emory Law Journal* 1115 (2004).

<sup>128</sup> *See* discussion of Dispute Resolution Forum *infra* in the section entitled “Dispute Resolution Forum.”

<sup>129</sup> Indeed, debt that is denominated in foreign currency will normally be converted into domestic currency, often at the time of commencement, with all distributions being made in domestic currency. In the United States, the applicable rule is set forth in 11 U.S.C. § 502(b). *See also UNCITRAL Legislative Guide, supra* note 111, Part Two, Chapter V(A), Section 2(c), Recommendation 175; IMF, *supra* note 111, at 45–46. However, the Proposed Features do not provide for such a conversion. Rather, claims would continue to be denominated and payable in their original currencies after commencement. Moreover, unlike the approach followed in most insolvency laws (at least for unsecured creditors), interest would continue to accrue at the contractual rate. The decision not to follow the corporate insolvency model in these areas was, in large part, motivated by a desire to limit the degree to which the SDRM would interfere with contractual relations. *See* SDRM Design, *supra* note 16, at 33–36.

<sup>130</sup> *See supra* note 34 for a discussion of the difficulty of enforcing claims against a sovereign when the action is brought within the sovereign’s territory.

<sup>131</sup> Professor Schwarcz reaches a similar conclusion regarding the seniority of external law claims for purposes of the design of his proposed Convention. *See* Schwarcz, *supra* note 83, at 1006.

<sup>132</sup> For a further discussion of these options, see “Sovereign Debt Restructuring Mechanism—Further Considerations,” *supra* note 16, at 9–12.

<sup>133</sup> *See* discussion *infra* in the section entitled “Improving the Dialogue.”

<sup>134</sup> Of course, they have greater political leverage than external creditors, thereby enabling them to press for preferential treatment. In these circumstances, the question would be whether external creditors would be



willing to tolerate such discrimination when deciding to accept the terms of any offer.

<sup>135</sup> “Proposed Features,” *supra* note 94, para. 3(b).

<sup>136</sup> The political implications of including debt governed by domestic law under the SDRM were identified by Charles Dallara, Managing Director of the International Institute for Finance, who is an outspoken critic of the SDRM: “Are the U.S. and U.K. governments really going to allow the IMF to intervene in private contracts undertaken by their own citizens under their own laws?” Alan Beattie, “Bankruptcy Plan Leaves IMF to Fill in the Detail,” *Financial Times* (November 29, 2001), at 15.

<sup>137</sup> For a description of the rescheduling procedures relied upon by the Paris Club, see Eichengreen et al., *supra* note 62, at 23–25; *see also* Rieffel, *supra* note 25, at 56–95.

<sup>138</sup> *See* discussion *supra* in the section entitled “Policies, Process, and Equity.” Interestingly, Professor Schwarcz also alludes to the inclusion of official bilateral claims as a separate class under his proposed Convention. *See* Schwarcz, *supra* note 83, at 1006. Unlike the Proposed Features, however, he also contemplates the inclusion of multilateral claims within the framework. *See id.* *See supra* note 129 for a discussion of the treatment of multilateral debt under the SDRM.

<sup>139</sup> For a discussion of the IMF staff’s own consideration of the relative advantages and disadvantages of including official bilateral claims within the SDRM, *see* “SDRM Considerations,” *supra* note 16, at 19–25.

<sup>140</sup> *See* “Proposed Features,” *supra* note 94, para. 3(d)(vi) n.2.

<sup>141</sup> *Id.* para. 3(d)(v).

<sup>142</sup> The benefits of the IMF’s preferred creditor status are articulated in the brief filed by the United States recently in the context of litigation involving Argentina:

The United States opposes any attempt by the judgment creditors to force Argentina to depart from well-established, internationally-accepted payment practices. Both policy and equity require that sovereigns be permitted to service their [International Financial Institution (IFI)] obligations. An interruption of the financial transactions between the IFIs, especially the IMF, and their members would substantially undermine the ability of the IFIs to fulfill their vital systematic public policy functions in promoting international economic and financial stability.

*Statement of Interest of the United States, supra* note 45, at 17–18.

<sup>143</sup> See *UNCITRAL Legislative Guide*, *supra* note 111, Part Two, Chapter II(D), Recommendations 63–68.

<sup>144</sup> In one publication, *Jubilee 2000*, a nongovernmental organization that advocates debt relief for sovereign debtors, noted the following:

IMF staff do not believe that the institution itself, a major creditor, should be included in the “debt standstill” agreement. In other words they are asking the sovereign debtor make [sic] an exception of the IMF, and to therefore treat “some creditors more favourably than others.” This preferential treatment of creditors, like the IMF, that have made major errors in lending and policy advice, is clearly unacceptable.

Ann Pettifor, “Resolving International Debt Crises—The Jubilee Framework for International Insolvency,” 12 (2002), [http://www.jubileeplus.org/analysis/reports/jubilee\\_framework.pdf](http://www.jubileeplus.org/analysis/reports/jubilee_framework.pdf).

<sup>145</sup> While state-owned enterprises often borrow on a secured basis, it was decided that the debt of such enterprises would not be included under the SDRM to the extent that they were already subject to a statutory debt restructuring framework. In addition to the government, the central bank or similar monetary authority of the member would be eligible to restructure their claims under the SDRM. See “SDRM Design,” *supra* note 16, at 14–17.

<sup>146</sup> As noted by one commentator, this is one of the biggest differences between the structure of sovereign and nonsovereign debt. See Jeremy Bulow, “First World Governments and Third World Debt,” 2002(1) *Brookings Papers on Economic Activity*, at 229.

<sup>147</sup> The negative pledge clause found in a typical international sovereign bonds provides as follows:

[Sovereign Debtor] has agreed that as long as any of its debt securities remain outstanding, it will not create or permit to exist any security interest on its revenues or assets to secure its public indebtedness, unless the debt securities are given an equivalent security interest.

<sup>148</sup> See *UNCITRAL Legislative Guide*, *supra* note 111, at 197–212, 216; IMF, *supra* note 111, at 64–65.

<sup>149</sup> In particular, a holder of a secured claim will often be able to foreclose on its collateral without the need for a judgment or any other form of judicial intervention.

<sup>150</sup> See *UNCITRAL Legislative Guide*, *supra* note 111, at 88–91; IMF, *supra* note 111, at 70.

<sup>151</sup> Negative pledge clauses can be found in the loans extended by the World Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank.

<sup>152</sup> The claims that were excluded under the Proposed Features included any claims that benefit from a statutory, judicial, or contractual privilege, to the extent of the value of such a privilege. “Proposed Features,” *supra* note 94, para. 3(d)(i). Two important exceptions were made to this carve-out. However, in the event that the judicial lien was created after commencement, the exclusion would not apply, thereby creating an additional disincentive against creditor litigation during the restructuring process. *Id.*

<sup>153</sup> For a discussion of the Asian financial crisis, see *The Asian Financial Crisis: Origins, Implications and Solutions* (William C. Hunter et al., eds., 1999); see also Timothy Lane et al., “IMF-Supported Programs in Indonesia, Korea, and Thailand—A Preliminary Assessment,” IMF Occasional Paper 178 (1999), <http://www.imf.org/external/pubs/ft/op/op178/op178.pdf>.

<sup>154</sup> Over the years, the question has arisen as to whether the existing text of Article VIII, Section 2(b) of the IMF’s Articles could be relied upon to provide debtors with protection against litigation in circumstances where the arrears arise exclusively from the imposition of exchange controls. The provision reads as follows: “Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.” *Articles of Agreement of the International Monetary Fund*, Article VIII, Section 2(b), <http://www.imf.org/external/pubs/ft/aa/aa.pdf>. This provision has not been interpreted uniformly by the courts of the IMF’s various members. Under the narrow interpretation—which prevails in the United States and the United Kingdom—exchange contracts have been interpreted in such a way that Article VIII, Section 2(b) is not applicable to credit agreements. Under a broader interpretation that prevails in a number of other jurisdictions, the IMF’s temporary approval of restrictions that fall within its jurisdiction on current payments (interest payments and moderate amortization of loan principal) will result in an automatic stay on creditor actions relating to the arrears that arise from the restrictions in question. The stay would lapse on the expiration of the IMF’s approval. While the IMF could adopt an authoritative interpretation along the above lines, it would not help with respect to other arrears relating to capital payments (e.g., nonpayment of bullet payments of principal). There are only two ways in which such arrears could be treated. Under one scenario, controls that give rise to such arrears would be treated as always being consistent with the IMF Articles. Alternatively, the term “consistent” could be interpreted more narrowly, as only including restrictions on current payments and transfers. Under this

interpretation, therefore, controls on capital payments would never be “consistent” with the IMF’s Articles. In any event, neither of these interpretations would enable arrears on capital payments to be temporarily protected on a conditional basis, i.e., only in situations where the IMF judged the arrears in question were justified. Accordingly, to achieve symmetry between the treatment of arrears arising from current and capital payments, it was recognized that an amendment of the IMF’s Articles would be required.

<sup>155</sup> For a further discussion of exchange controls under the SDRM, see “Preliminary Considerations,” *supra* note 16, at 15.

<sup>156</sup> As discussed earlier, this limitation represents an important departure from the approach taken in the nonsovereign context, where creditors are often given the right to initiate proceedings under the reorganization law. See *UNCITRAL Legislative Guide*, *supra* note 111, at 50–52; IMF, *Orderly and Effective Insolvency Procedures—Key Issues* (Washington: IMF, 1999), at 53–54.

<sup>157</sup> See “Preliminary Considerations,” *supra* note 16, at 12.

<sup>158</sup> The initial proposal also envisaged the IMF playing a similar role at the time of the mechanism’s termination. Specifically, once a debtor and a qualified majority of its creditors had agreed upon a debt restructuring agreement, IMF endorsement would be a necessary condition for the effectiveness of this agreement. Absent such an endorsement, there was a fear that the debtor and creditors may agree upon debt restructuring terms that were not sustainable—thereby placing an undue burden on the member’s adjustment program or future financing from the IMF. However, the Proposed Features did not provide such a role for the IMF.

<sup>159</sup> See discussion of automatic stay *infra* in the section entitled “The Stay on Creditor Enforcement.”

<sup>160</sup> “Proposed Features,” *supra* note 94, para. 6.

<sup>161</sup> As noted by Patrick Bolton, one of the concerns expressed by governments of emerging market economies was that the ability of a sovereign to initiate the mechanism on a purely voluntary basis would increase the domestic political pressure on these governments to default on their external debt. See Bolton, *supra* note 63, at 15.

<sup>162</sup> See discussion *supra* in the section entitled “Overview” regarding economic costs of restructuring and the impact such costs have on the incentives of economic policymakers.

<sup>163</sup> See “Preliminary Considerations,” *supra* note 16, at 12–13.

<sup>164</sup> “Proposed Features,” *supra* note 94, para. 7(b).

<sup>165</sup> See discussion of the design of majority enforcement provisions *supra* in the section entitled “The Existing Tools: Collective Action Clauses.”

<sup>166</sup> Professor Schwarcz’s decision not to provide for any form of stay on enforcement under his own proposal is motivated, in part, by the view that such a stay would not be necessary, given the absence of strong creditor enforcement mechanisms in the sovereign context. See Schwarcz, *supra* note 83, at 984–85.

<sup>167</sup> In the United States, for example, a debtor may not pay pre-petition claims after commencement unless the court determines that, under the “doctrine of necessity,” such payments are necessary for the continuation of the debtor’s business. 11 U.S.C. § 105(a).

<sup>168</sup> See discussion *infra* note 184 and accompanying text.

<sup>169</sup> See discussion of information provided by the sovereign to its creditors *infra* in the section entitled “Improving the Dialogue.”

<sup>170</sup> As is discussed in the *UNCITRAL Legislative Guide*, laws vary as to the degree to which incumbent management is displaced from control. While some laws provide for complete displacement, others allow for a form of power sharing between management and a court-appointed administrator. The ability of management to retain completed control, as provided under Chapter 11, does not represent the approach relied upon by most countries. *UNCITRAL Legislative Guide*, Part Two, Chapter III(A), Section 2. Even under Chapter 11, however, in the event that management takes actions that adversely affects the interests of creditors, the court can remove it from power. 11 U.S.C. § 1142.

<sup>171</sup> See Bolton and Skeel, *supra* note 63, at 325.

<sup>172</sup> See discussion of credit enforcement *supra* in the section entitled “The Stay on Creditor Enforcement.” To the extent that a creditor’s claim is secured, it may have the ability to foreclose on its collateral through self-help remedies, i.e., without the need for judicial intervention.

<sup>173</sup> See discussion regarding the type of claims that would be subject to the SDRM *supra* in the section entitled “The Scope of Debt.”

<sup>174</sup> Moreover, to the extent that the creditor had received a judicial lien after the commencement of proceedings, this claim, unlike other secured claims, would not be excluded from the SDRM. See *supra* note 152 and accompanying text.

<sup>175</sup> See Ian E. Fletcher, *The Law of Insolvency*, at 29–38 (3rd ed. 2002).

<sup>176</sup> See “Proposed Features,” *supra* note 94, para. 7(a). Let us say, for example, that a creditor possessing a claim with a face value of US\$10 million uses judicial enforcement measures to seize assets worth US\$4

million. When a restructuring agreement is finally reached, creditors receive a distribution equivalent to 50 percent of their original claims. Applying the hotchpot rule, the judgment creditor would only receive US\$1 million, i.e., 50 percent of its original claim (US\$5 million) as further reduced by the full amount recovered through the court system. In the absence of such a rule, the creditor would have received US\$3 million under the restructuring agreement.

<sup>177</sup> Professors Bolton and Skeel have also suggested the inclusion of a targeted stay, but as an alternative rather than a supplement to a general stay. See Bolton and Skeel, *supra* note 63, at 325–27.

<sup>178</sup> Litigation would be particularly disruptive if, for example, there was sufficient evidence that the creditor seeking enforcement could attach sufficient assets to circumvent the operation of the hotchpot rule described above.

<sup>179</sup> See “Proposed Features,” *supra* note 94, para. 7.

<sup>180</sup> *Id.* para. 5.

<sup>181</sup> *Id.* para. 8.

<sup>182</sup> See IMF, *supra* note 77, at 626–32. Under the IMF’s existing publication policy, the publication of both the member’s letter of intent (which sets forth the economic adjustment program) and the relevant staff report (which assesses this program and explains why it justifies IMF financial support) are subject to the consent of the member concerned. However, the policy provides that such consent will be presumed. Accordingly, where a member does not wish to consent to IMF publication of a document, the member would need to notify the IMF of this decision and provide an explanation. *Id.* at 626.

<sup>183</sup> See “Proposed Features,” *supra* note 94, para. 5.

<sup>184</sup> This list would also include claims of multilateral organizations. Moreover, the list would also include claims of official bilateral creditors in the event that a decision was made to exclude such claims from the coverage of the SDRM. See discussion *supra* in the section entitled “Overview.”

<sup>185</sup> Because of concerns regarding state sovereignty, the provisions of the SDRM regarding the provision of information would not constitute legal obligations of the sovereign. Instead, adherence to these provisions would constitute a condition for the availability of the mechanism’s restructuring provisions.

<sup>186</sup> For a discussion of the role of steering committees during the debt crisis, see Reiffel, *supra* note 25, at 95–132; Buchheit, *supra* note 26.

<sup>187</sup> Although the existence of a trustee for each bond issuance provides, in theory, some framework of representation, trustees have traditionally been very cautious about speaking on behalf of bondholders during a restructuring process, largely because of concerns regarding their own liability. *See, e.g.*, L. Buchheit, “The Representation Clause,” 17 *International Finance Law Review* 9 (September 1998).

<sup>188</sup> In the case of Ecuador, the stated reluctance by the debtor to deal with a creditors’ committee was based on a concern that sensitive information disclosed during the negotiations would either be leaked or be traded on. *See* “Involving the Private Sector,” *supra* note 57, at 7.

<sup>189</sup> Perhaps the most notable effort in this area is the “Statement of Principles for a Global Approach to Multi-Creditor Workouts,” prepared by the International Association of Restructuring, Insolvency, and Bankruptcy Practitioners (INSOL) in 2000. *See* <http://www.insol.org>. Among other things, the Statement of Principles establishes a framework that accommodates the trading of claims during the restructuring process and, more generally, the diversity and multiplicity of creditor interests through the establishment of different subcommittees.

<sup>190</sup> *See* Council on Foreign Relations, Roundtable on Country Risk in the Post-Asia Crisis Era: Key Recommendations, [http://www.cfr.org/publication/8693/roundtable\\_on\\_country\\_risk\\_in\\_the\\_postasia\\_crisis\\_era.html](http://www.cfr.org/publication/8693/roundtable_on_country_risk_in_the_postasia_crisis_era.html). Consistent with the approach followed in the INSOL Statement of Principles, the Council on Foreign Relations principles provide guidance with respect to (i) the modalities of creditor organization (including the establishment of subcommittees), (ii) expectations regarding the debtor behavior (including the provision of information), (iii) retention of financial advisors (and the expectation that the debtor will bear the reasonable expenses of these advisors), and (iv) standstill on litigation during the negotiation period.

<sup>191</sup> *See* IMF, *supra* note 77, at 309.

<sup>192</sup> *See* discussion of possible role of a creditors’ committee in the context of a targeted stay *supra* note 177 and accompanying text.

<sup>193</sup> *See* discussion of stay on enforcement actions *supra* in the section entitled “The Stay on Creditor Enforcement.”

<sup>194</sup> *See* IMF, *supra* note 77, at 309.

<sup>195</sup> First, the committee would need to include those creditors with the greatest exposure to the sovereign. Second, it should be sufficiently representative of the diverse financial and economic interests of the claims being restructured. Thus, for example, it may be necessary to include claims held by both institutional and retail investors. Third, the size would need to

be sufficiently small to enable it to operate in an efficient manner. See “SDRM Design,” *supra* note 16, at 43.

<sup>196</sup> See *UNCITRAL Legislative Guide*, *supra* note 111, at 182–86; IMF, *supra* note 111, at 75–76. In the United States, for example, the expenses of the committee are treated as an administrative expense of the estate. See 11 U.S.C. § 503(b)(4).

<sup>197</sup> See Reiffel, *supra* note 25, at 129.

<sup>198</sup> “Proposed Features,” *supra* note 94, para. 8.

<sup>199</sup> For a detailed discussion of how regulatory issues shaped the strategy that was relied upon during the 1980s debt crisis, see generally Lee Buchheit, “Alternative Techniques in Sovereign Debt Restructuring,” 1988 *University of Illinois Law Review* 371 (1988). See also Reiffel, *supra* note 25, at 127.

<sup>200</sup> See Reiffel, *supra* note 25, at 126. See generally Buchheit, *supra* note 199.

<sup>201</sup> For Professor Schwarcz, the creation of a priority structure that would shift financing away from the IMF and toward the private sector would serve to address not only moral hazard problems but would “eliminate the need for taxpayers to pay for the funding and would avoid politicizing the decisions of when and to whom the IMF should make funding available.” See Schwarcz, *supra* note 83, at 987.

<sup>202</sup> It is very likely, however, that trade creditors—because of the short-term nature of their claims—would be willing to provide financing even in the absence of any formal assurances regarding the priority of their claims.

<sup>203</sup> “Proposed Features,” *supra* note 94, para. 10.

<sup>204</sup> For the law of the United States, see 11 U.S.C. 364 (a), (b); *UNCITRAL Legislative Guide*, *supra* note 111, at 105–10.

<sup>205</sup> See discussion of negative pledge clauses *supra* in the section entitled “The Scope of Debt.”

<sup>206</sup> For an exploration of the feasibility of using a contractual framework to provide for a priority structure, see Buchheit and Gulati, *supra* note 51, at 1348–50. Of course, one of the limitations of this approach is that the framework would not aggregate claims across instruments.

<sup>207</sup> See discussion of negative pledge clauses *supra* in the section entitled “The Scope of Debt.”

<sup>208</sup> For issues relating to the classification of claims and voting procedures, see *UNCITRAL Legislative Guide*, *supra* note 111, at 197–210, 235–39.

<sup>209</sup> “Proposed Features,” *supra* note 94, para. 6.



<sup>210</sup> *Id.*

<sup>211</sup> The rule that a claim is presumptively valid unless challenged by the debtor or a creditor is one that is relied upon in the United States in the nonsovereign context. *See* 11 U.S.C. § 502(a). This approach is efficient since it avoids the need for each claim to be subject to a verification procedure.

<sup>212</sup> One of the challenges that arise when designing any registration and verification framework relates to the disclosure of the end-investor. Under existing practice in the sovereign market, private settlement companies and their depositories are the lenders of record for voting purposes and hold the sovereign securities in global form. The beneficial owners of these securities normally have accounts with large financial institutions that, in turn, have accounts with these settlement companies. In these circumstances, would a creditor be in a position to meaningfully challenge a claim—either for distribution or voting purposes—unless it knew the identity of the end-investor? While there is considerable attraction to requiring such disclosure, it would not necessarily resolve the problem since, for example, the sovereign could always establish a special purpose vehicle as the end-investor. An alternative approach that was recently used in the context of the restructuring of Uruguay’s external bonds would be to require the sovereign to certify that none of the bonds being voted on are owned or controlled by the sovereign.

<sup>213</sup> “Proposed Features,” *supra* note 94, para. 11. This 75 percent threshold is the same that was advocated for collective action clauses by the G-10 Deputies Working Group, and which has become the emerging standard for bonds governed by New York law. *See* “G-10 Deputies Report,” *supra* note 59; “Progress Report,” *supra* note 54, at 7 n.11. The decision to calculate this percentage on the basis of all registered and verified claims—rather than on the basis of those registered and verified claims attending a duly convened meeting—also took into account concerns that U.S. institutional investors had expressed during discussions of the design of majority restructuring provisions. “G-10 Working Group Report,” *supra* note 52, at 4–5.

<sup>214</sup> “G-10 Working Group Report,” *supra* note 52.

<sup>215</sup> *See* discussion of scope of claims under Part III of Appendix III.

<sup>216</sup> International sovereign bonds typically provide that, upon the occurrence of an event of default, the holders of the bonds may declare that the entire amount outstanding under the bond becomes due and payable. As has been discussed, above, the activation of acceleration provisions may require the support of bondholders representing at least 25 percent of outstanding principal. *See* discussion *supra* text accompanying note 55.

<sup>217</sup> See discussion of prepackaged bankruptcy procedures *supra* note 103 and accompanying text; *UNCITRAL Legislative Guide*, *supra* note 111, at 218–23.

<sup>218</sup> See *UNCITRAL Legislative Guide*, *supra* note 111, at 203; IMF, *supra* note 111, at 66–67.

<sup>219</sup> As another example, a sovereign may need to restructure claims that were originally interbank claims or trade credit but have become claims on the sovereign because a guarantee had been called. In these cases, the sovereign may need to provide these creditors with terms that are preferable to those offered to bondholders because of the need to resume normal interbank and trade financing after the crisis subsides. Since these preferential terms could only be offered to bank creditors they would be placed in a separate class from bondholders. Bondholders may be willing to accept being treated less favorably because of the recognized need to resume trade credit.

<sup>220</sup> “Proposed Features,” *supra* note 94, para. 11(d).

<sup>221</sup> In the corporate context, this risk can be particularly problematic where the law allows for “cram down,” i.e., where a restructuring plan can become effective notwithstanding the fact that the plan did not receive adequate support from a number of creditor classes. As discussed earlier, however, the Proposed Features would require the support of each class for a restructuring to go forward. See discussion *supra* in the section entitled “The Scope of Debt.”

<sup>222</sup> For example, a debtor would presumably be precluded from creating two different classes of unsecured creditors where certain interbank claims creditors are placed in their own class and given short-term instruments while other inter-bank creditors are placed in another class with bondholders and are given long-term instruments.

<sup>223</sup> See “Proposed Features,” *supra* note 94, para. 13.

<sup>224</sup> For a discussion of registration and verification, see Part VIII of Appendix III.

<sup>225</sup> For issues relating to creditors’ committees, see Part VIII of Appendix III.

<sup>226</sup> For example, under U.S. bankruptcy law, a reorganization plan must be approved by the court on the basis of the criteria set forth in the law. 11 U.S.C. § 1129. In particular, the court must determine that “confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor of the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.” *Id.* at § 1129(11); see also *UNCITRAL Legislative Guide*, *supra* note at 111, at 201–10.

<sup>227</sup> As discussed earlier, the imperative of creating a dispute resolution forum with limited powers and discretion was also advanced by Professor Schwarcz. See Schwarcz, *supra* note 83, at 980.

<sup>228</sup> It has been noted that making an assessment as to whether a country's debt is unsustainable involves difficult judgments regarding the feasibility of the member's adjustment capacity. See *supra* in the section entitled "Collective Action Problems." Such an assessment is relevant not only for purposes of determining whether a country should activate the SDRM but also for whether it is ready to exit the mechanism, i.e., does the agreement that it has reached with its creditors provide for true debt sustainability? To the extent that it does not, there is a risk that the restructuring exercise would need to be repeated or that further pressure would be placed on the IMF to provide additional financing.

<sup>229</sup> For information regarding composition of the DRF, see *infra* text accompanying notes 237–44.

<sup>230</sup> See "Proposed Features," *supra* note 94, para. 13.

<sup>231</sup> Other international dispute resolution bodies also have some rule-making authority. Under Article 30(1) of the Statute of the International Court of Justice (ICJ), the ICJ has been granted the authority to establish rules of procedure and rules for its internal workings. The Appellate Body of the World Trade Organization has authority to establish its rules of procedures if it is done in consultation with the Chairman of the Dispute Settlement Body. See *General Agreement on Tariffs and Trade—Multilateral Trade Negotiations (The Uruguay Round): Understanding on Rules and Procedures Governing the Settlement of Disputes*, December 15, 1993, art. 17(9), 33 I.L.M. 112 (1994).

<sup>232</sup> Thus, while the Board of Governors could veto the rules adopted by the DRF, it could not take the initiative and adopt its own rules. This balance of authority was designed to address the risk of excessive interference by the IMF's other organs in the operation of the SDRM.

<sup>233</sup> Under Article XXXI, Section 2 of the IMF Articles, members have the obligation to ensure that they have taken all steps necessary to enable it to carry out all of its obligations under the Agreement. *IMF Articles*, *supra* note 5, Article XXXI, Section 2.

<sup>234</sup> Critics of the SDRM identified this feature as being problematic from both a policy and a legal perspective: "This *ex post facto* modification through legislative fiat of contractual rights is troubling not only out of abstract concerns about fairness, but also because it strikes at the very heart of the market's confidence in the sanctity of private contracts and, thus, the rule of law." Galvis, *supra* note 115, at 149.

<sup>235</sup> For a discussion of the insolvency reforms introduced during the Asian crisis, see Sean Hagan, “Insolvency Reform and Economic Policy,” 17 *Connecticut Journal of International Law* 63, at 63–73 (2001).

<sup>236</sup> Similarly, Professor Schwarcz concludes that his proposed Convention could apply to claims in existence at the time of ratification. See Schwarcz, *supra* note 83, at 1012–14.

<sup>237</sup> See discussion of IMF workshop and conference *supra* note 18. Among those providing advice on the design of the SDRM was the Honorable Burton Lifland, Chief Judge of the U.S. Bankruptcy Court. See “IMF Consults Widely,” *supra* note 18.

<sup>238</sup> See *U.N. Charter* art. 92–96.

<sup>239</sup> The de jure independence of the DRF would be established in the text of the treaty provisions themselves. Specifically, the amendment to the IMF’s Articles would provide that the decisions of the DRF would not be subject to the review of any of the IMF’s other organs (other than the DRF’s rule-making authority, see *supra* the section entitled “Dispute Resolution Forum”) and that the members of the DRF would not be subject to any influence of these organs or the management or staff of the IMF. As a means of ensuring security of tenure for DRF members, the text of the amendment would also specify the grounds for their dismissal.

<sup>240</sup> See “Proposed Features,” *supra* note 94, para. 13(a)(i).

<sup>241</sup> *Id.* para. 13(a)(ii).

<sup>242</sup> Based on consultation with the private sector, there was a view that the candidates should be limited to judges that have demonstrated experience in insolvency, but not academics or practitioners. However, because the available pool of such judges could be relatively small, there was a recognition that retired judges should also be eligible.

<sup>243</sup> See “Proposed Features,” *supra* note 94, para. 13(a)(iii).

<sup>244</sup> Notwithstanding these safeguards, some continue to believe that the very fact that the legal instrument establishing the DRF would be the IMF’s Articles would effectively preclude independence from the IMF. See, e.g., Boeri, *supra* note 116, at 250.

<sup>245</sup> *IMF Articles*, *supra* note 5, Article. XXVIII(a).

<sup>246</sup> Paul O’Neill, U.S. Secretary of the Treasury, “The Condition of the Financial Markets, Testimony Before the Senate Committee on Banking, Housing and Urban Affairs,” 107th Cong., S. Hrg 107–606, at 33 (2001).

<sup>247</sup> In his statement at the April 12, 2003, meeting of the International Monetary and Financial Committee, Secretary Snow stated the following:

The IMF's exploration of a sovereign debt restructuring mechanism has raised important issues. But clearly, given the reactions of markets and emerging-market countries, we should move forward with collective action clauses. These clauses, and not a centralized mechanism, are the vehicle to resolve the issues connected with sovereign debt restructuring. There can at times be "collective action" problems that prevent a prompt, orderly resolution of a sovereign debt crisis. The source of these problems lies in the relationships and agreements of debtors and creditors. It is these parties, not an international organization, that must assume responsibility for the solution. Therefore, it is neither necessary nor feasible to continue working on SDRM.

*Meeting of the International Monetary and Financial Committee*, IMF (April 12, 2003) (statement by Sec. John W. Snow, U.S. Treasury), <http://www.imf.org/external/spring/2003/imfc/state/eng/usa.htm>.

<sup>248</sup> See discussion of developments with collective action clauses in New York law-governed bonds *supra* in the section entitled "The Legal Environment."

<sup>249</sup> Cf. "Battling over the Bankrupt," *The Economist* (October 5, 2002), at 71 ("The chances of America's Congress agreeing to such a change in the Fund's rules are slim. That is why America's Treasury insisted on pushing a second market-based approach.").

<sup>250</sup> It has been observed that the reluctance of the United States to surrender any national sovereignty in this context is consistent with its hesitancy to do so in other areas. See, e.g., Wheeler and Attaran, *supra* note 28, at 264 ("From a U.S. perspective, it is difficult to imagine a Congress that has been unwilling to sign away sovereignty to an international criminal court doing so in an area that implicates property interests.").

<sup>251</sup> A number of leading financial industry associations joined forces to lobby against the SDRM proposal. The associations consisted of the Institute for International Finance, the Emerging Market Traders Association, the International Primary Market Association, the Bond Market Association, the Securities Industry Association, the International Securities Market Association, and the Emerging Market Creditors Association.

<sup>252</sup> See Michael M. Philips, "Support Plan Builds for Plan to Ease Debt Loads of Developing Nations," *Wall Street Journal* (September 17, 2002), at A16.

<sup>253</sup> For a discussion of differences of view between "buy-side" and "sell-side" creditor groups on the SDRM, see Melvyn Westlake, "Battle of the Heavyweights," *Emerging Markets* (September 27, 2002), at 16.

<sup>254</sup> The various stated and unstated concerns of the private sector are well summarized in “A Better Way to Go Bust,” *The Economist* (February 1, 2003), at 64.

<sup>255</sup> See Galvis, *supra* note 115.

<sup>256</sup> See discussion *supra* text accompanying note 68.

<sup>257</sup> Letter from Charles H. Dallara, Managing Director, IIF et al. to Dr. A.H.E.M. Wellink, Governor, De Nederlandsche Bank NV (December 6, 2002).

<sup>258</sup> The private sector was very suspicious about the motives behind the SDRM:

The underlying problem is suspicion: bankers, bondholders, and many emerging-market borrowers worry that the IMF has a hidden agenda. The IMF could use the SDRM, once it is in place, as an excuse to trim official bail-outs, by demanding that the private sector take more of the strain when governments run into trouble.

“A Better Way to Go Bust,” *The Economist* (February 1, 2003), at 64.

<sup>259</sup> In assessing the private sector’s opposition to the SDRM, Bolton and Skeel identified “principled” and “less principled” objections to the SDRM:

The principled objection to sovereign bankruptcy is the risk that an SDRM will make it too easy for sovereign debtors to default. Much as bailouts create moral hazard on the part of creditors, sovereign bankruptcy could have a similar effect on debtors. Limiting sovereign debtors’ ability to restructure, on this view, encourages sovereigns to repay what they owe. The less principled explanation for the underwriters’ and investors’ opposition is simply that the existing bailout approach usually assures that bondholders will be made whole. If an SDRM replaced bailouts as the strategy of choice, sovereign debt holders could no longer count on a handout when sovereigns encountered financial distress.

Bolton and Skeel, *supra* note 63, at 308.

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**Inside the Black Box: How Should a  
Sovereign Bankruptcy Framework Be  
Structured?**

PATRICK BOLTON AND DAVID A. SKEEL, JR.

For at least two decades now, commentators have suggested that international policymakers should establish a sovereign bankruptcy regime.<sup>1</sup> The reasoning is quite simple. Given that financially distressed sovereign debtors face many of the same problems that justify personal and corporate bankruptcy, such as the difficulty of coordinating the debtor's widely dispersed creditors, why not consider the same kind of solution in the case of sovereign distress?

Until quite recently, these proposals were viewed as intriguing, but a bit far-fetched. In the past several years, however, everything has changed. Sovereign bankruptcy has suddenly become a front-burner issue in international finance. Nothing epitomizes the extent to which sovereign bankruptcy has entered mainstream discussion so much as the stance of the International Monetary Fund (IMF). In recent years, financially troubled sovereign debtors have come to rely increasingly on IMF loan programs as a mechanism for addressing fiscal crisis.<sup>2</sup> Although originally somewhat skeptical, the IMF has become increasingly sympathetic to the sovereign bankruptcy concept as the cost of its interventions has dwarfed its resources. In 2002, the IMF explicitly endorsed the sovereign bankruptcy concept. The IMF is now the leading institutional proponent of sovereign bankruptcy and has developed a detailed proposal for what the IMF calls a "Sovereign Debt Restructuring Mechanism" (SDRM).<sup>3</sup> Sovereign bankruptcy has figured prominently in other venues as well, such as the recent meetings of the Group of Seven (G-7) and Group of Ten (G-10) nations. The most obvious explanation for the recent interest in sovereign bankruptcy is that the crises of the 1990s, such as the bailout of Mexico in 1995, the Asian crisis in 1997, and the turmoil in Argentina and Brazil thereafter, have cast an unflattering light on the traditional strategies for dealing with financial crisis. The regnant approach has relied largely on the IMF's willingness to "lend into



arrears,” if necessary, to spearhead a bailout. As the recent crises have made clear, one problem with IMF-led bailouts is simply that the IMF does not have infinite funds at its disposal. The bailout of Mexico in 1995 was a major success, for instance, but the need for substantial outside aid underscored the limits of the IMF’s resources. A second problem is that bailouts create a serious risk of creditor moral hazard. If creditors know (or believe) they can count on the IMF to come in and pick up the pieces when a sovereign defaults, they will be much more careless in their lending than would otherwise be the case.

Not everyone has joined the sovereign bankruptcy bandwagon. The most vigorous opponents of an SDRM are the banks and lawyers who underwrite sovereign bonds in New York, together with investors that currently hold them. “We continue to believe that this is not a productive way forward,” the head of the Institute of International Finance (IIF) has complained. “[A]t a time of extreme risk-aversion in emerging markets, when capital flows are falling, approaches such as [the IMF plan] add further to uncertainty and investor anxiety.”<sup>4</sup> The hostility reflected in statements like this is based in part on principle and in part on obvious self-interest. The principled objection to sovereign bankruptcy is the risk that an SDRM will make it too easy for sovereign debtors to default. Much as bailouts create moral hazard on the part of creditors, sovereign bankruptcy could have a similar effect on debtors. Limiting sovereign debtors’ ability to restructure, in this view, encourages sovereigns to repay what they owe. The less principled explanation for the underwriters’ and investors’ opposition is simply that the existing bailout approach often assures that bondholders will be made whole. If an SDRM replaced bailouts as the strategy of choice, sovereign debt holders could no longer count on a handout when sovereigns encountered financial distress.

Rather than either sovereign bankruptcy or the status quo, some observers, including the U.S. Treasury, have advocated still another, intermediate strategy for addressing sovereign financial distress: sovereign debtors, they argue, could use collective action provisions (also referred to as “CACs” or “majority voting provisions”) to restructure sovereign debt.<sup>5</sup> CAC provisions authorize a specified majority, often 75 percent, of the holders of an issuance of bonds to

agree to restructure the bond's payment or timing terms. Sovereign debt issued under U.K. law, which currently constitutes roughly 40 percent of sovereign debt, already includes these provisions, but until recently New York bonds did not.<sup>6</sup> Collective action enthusiasts argue that, if CACs were included in all sovereign debt, these provisions would provide a simpler and less intrusive way to restructure sovereign debt if necessary. Skeptics, on the other hand, have pointed out that collective action provisions are an inadequate substitute for the benefits of sovereign bankruptcy—benefits such as global rather than ad hoc restructuring and access to interim financing.<sup>7</sup>

Now is an auspicious time to take a closer look at sovereign bankruptcy given the enormous importance of the decision as to whether to establish an SDRM. The early sovereign bankruptcy proposals were understandably vague; they tended to identify the key attributes of an effective bankruptcy framework without hammering out the specific details.<sup>8</sup> Now that sovereign bankruptcy is no longer simply speculative, the IMF and other policymakers have started venturing inside the “black box” to offer more complete proposals for sovereign bankruptcy. The goal of this chapter is to contribute to this discussion by offering both careful analysis and a novel perspective on the key issues.

Perhaps the single most important theme of our analysis—a theme to which we will return repeatedly—is the importance of promoting adherence to absolute priority wherever possible.<sup>9</sup> Now, for many critics of sovereign bankruptcy, this is precisely the problem with an SDRM. As discussed above, the most frequent objection to sovereign bankruptcy is that an SDRM would make it too easy for sovereigns to default, thus interfering with creditors' rights and roiling sovereign credit markets. Existing evidence suggests that the complaints are overstated. Sovereigns are reluctant to default on their debt, and do so only as a last resort because of the reputational consequences of default in the event the sovereign wishes to return to the credit markets in the future. Similarly, sovereign debtors value their membership in the IMF and its programs, so they go out of their way to repay their obligations if there is any way they can, lest the sovereign jeopardize its relationship with the IMF. The more surprising and interesting point, however, is this: sovereign

bankruptcy can actually assure greater adherence to absolute priority than the status quo. Because it is often impracticable to lend to sovereigns on a collateralized basis, creditors currently have great difficulty assuring that their priorities will be honored. Even ostensibly collateralized obligations, moreover, may not guarantee priority treatment. When Ecuador faced a debt crisis in 1999, observers assumed that its collateralized Brady bonds would have priority over its uncollateralized bonds. But Ecuador opened restructuring negotiations with holders of the collateralized bonds first, and in doing so, effectively undermined the ostensible seniority structure.<sup>10</sup> When push came to shove, the priorities simply collapsed, a result that several prominent commentators think “is likely to drive away potential senior creditors.”<sup>11</sup>

In this chapter, we argue that the classification and voting rules of an SDRM can be used to address this problem. The emphasis on creditor priorities is an important distinction between our proposal and the plan that has been advocated by the IMF. Although the IMF plan, like ours, is designed to solve the ex post collective action problems that interfere with creditors’ ability to restructure troubled sovereign debt, the IMF does not systematically consider the ex ante implications of the SDRM. By focusing almost exclusively on ex post considerations, the IMF has not been able to respond satisfactorily to debtors’ and creditors’ concerns that the SDRM may result in higher costs of borrowing and a lower volume of debt for emerging market countries. Our proposal remedies this shortcoming by taking the ex ante effects of the SDRM much more fully into account. A central theme of our analysis is that, by promoting adherence to absolute priority, the SDRM could plausibly result in lower costs of borrowing ex ante.

As a baseline, we argue that the SDRM should enforce strict, first-in-time absolute priority. Bonds issued first would have priority over those issued later unless the sovereign and its creditors explicitly contracted around this rule. The only exceptions to first-in-time priority would involve trade debt, which would always be treated as a priority obligation, and collateralized lending (which would be given priority treatment under some circumstances). Against this backdrop, we propose a two-step classification and voting process for confirming a restructuring plan. The debtor would first make a pro-

posal as to how much its overall debt would be scaled back—that is, how large the overall “haircut” to creditors would be. If a majority of all creditors approved the haircut, the second step would simply entail reducing the creditors’ claims in this amount, starting with the lowest priority creditors and working up the priority hierarchy. This two-step approach not only would reinforce the creditors’ priorities within the SDRM, but also would clarify their priorities outside of the restructuring process.

In addition to classification and voting, the discussion also offers new insights into four other key issues. The first is whether litigation should be stayed when a sovereign initiates the bankruptcy process. Although the stay is less crucial for sovereigns than with ordinary debtors, since it is difficult to foreclose on sovereign assets, we argue that the SDRM should include at least a limited stay. We propose in particular that the SDRM impose a stay on asset seizures, but that litigation by creditors otherwise be permitted to go forward. As an alternative, sovereigns could be permitted to appeal to the SDRM for injunctive relief in the event creditors obtain a judgment. Both approaches have the virtue of halting potentially destructive creditor collection efforts without interfering with activities that are unlikely to impede the restructuring effort.

The second issue is financing the restructuring process. Every existing SDRM proposal calls for an approach modeled on the debtor-in-possession (DIP) financing provision that authorizes interim financing for U.S. corporate debtors, but the proposals differ significantly in their details. The framework we propose is based on a simple distinction between proposals we categorize as presumptively permissible, and those that are presumptively impermissible. Because of the risk that priority treatment for the DIP lender will encourage overborrowing, we argue that the presumptively permissible category should be limited to the financing of the sovereign’s trade debt. Although larger loans would not be prohibited, they would be permitted only if a majority of the sovereign’s creditors agreed to the financing.

The third issue is who should oversee the restructuring process. On this question, we call for a sharply different approach than does the IMF or the prior literature. The most prominent recent proposals would vest authority in a panel of experts set up by a new or existing international organization. The problem with this approach is that both the selection process and the panel's decision making would be susceptible to political jockeying. Rather than oversight by committee, we argue that the sovereign debtor should be permitted to choose, as SDRM decision maker, the bankruptcy or insolvency court of any jurisdiction where the sovereign has issued bonds. (Currently, this is likely to mean New York, London, Frankfurt, or Tokyo.) Not only would judges make better decision makers than the experts selected by a bureaucratic process, but giving sovereigns a choice would promote jurisdictional competition and, as a result, further enhance the decision-making process. The competition would be loosely analogous to the benefits of venue choice for corporate debtors in the United States.

The final major issue we consider is one that has not been addressed at all by prior commentators: whether the SDRM should be mandatory, or whether sovereigns should have the choice of opting out of the framework by crafting their own SDRM provisions. We argue that there are both theoretical and practical reasons to permit opt-out. From a theoretical perspective, opt-out would enhance efficiency by enabling a country to tailor the SDRM to its own circumstances. More practically, the opt-out option might increase sovereign debtors' willingness to agree to an SDRM. We also consider whether provisions that make the SDRM harsher should be precluded. Although sovereigns arguably have too great an incentive to agree to harsh provisions, we conclude, on balance, that opt-out should not be restricted in most cases.

Each of our proposals is designed to take both theoretical and political considerations into account. The framework we propose is entirely new, but it is shaped by the reality that political considerations are likely to rule some theoretically attractive solutions as out of bounds.

The first section of this chapter explores the principal alternatives to sovereign bankruptcy—collective action provisions and the status quo—and explains why neither is an adequate substitute for an SDRM. In the next section, we provide a brief overview of the IMF’s current proposal and note some of its principal shortcomings—primarily, its inadequate consideration of the SDRM’s *ex ante* effects. In subsequent sections, our proposal is developed by first taking up the question of whether to impose a stay on litigation. This is followed by outlining the classification and voting scheme and addresses the issue of interim financing. Next, we defend our argument that oversight should be vested in existing bankruptcy and insolvency courts. We then complete the discussion by discussing opt-out and tie the analysis together with a brief conclusion.<sup>12</sup>

### **Why Do We Need a Sovereign Bankruptcy Framework?**

Establishing a sovereign bankruptcy framework ranks quite high on just about any scale of intrusiveness one can imagine when it comes to dealing with sovereign debt issues. Now that the IMF has thrown its weight behind the concept, there is more support for some kind of SDRM than ever before. But sovereign bankruptcy would mark a significant departure from existing practice. And many of the central players in the world of sovereign debt—ranging from the Wall Street banks that underwrite much of the debt to some of the sovereign debtors themselves—are opposed to this strategy.

Given this resistance, we begin by asking whether sovereign bankruptcy is really necessary. Both in the literature and in practice, partisans have argued fervently for two kinds of alternatives to a full-blown SDRM. First, some commentators have argued that we should leave things right where they are, not *despite* the difficulty sovereigns have in restructuring their obligations in times of financial distress, but *because of* it. These commentators extol the benefits of tough restrictions on *ex post* renegotiation. The second option is to rely on majority voting provisions in sovereign debt. Advocates of this approach believe it is necessary to facilitate a restructuring in the event the sovereign encounters financial distress, but they believe that the best way to do this is by including voting provisions in each issue of sovereign bonds.

The discussion that follows briefly considers each of these alternatives. Unfortunately, neither the status quo nor contractual voting provisions are an adequate response to sovereign financial turmoil.

### **Tough Love: Making It Hard to Restructure Sovereign Debt**

The simplest solution of all would be to leave things more or less as they are, and several important commentators have called for precisely this.<sup>13</sup> Advocates of the status quo acknowledge that the sovereign debt restructuring process is highly inefficient under current conditions, but they see the ex post inefficiency as a virtue rather than a problem. The key benefit of tough restructuring rules, in this view, comes from their ex ante effect. Because sovereign debtors know they cannot easily renegotiate their debt ex post, they will have a powerful incentive to repay the obligations. More flexible renegotiation rules, by contrast, would undermine the sovereign's commitment to repay and would increase the sovereign's ex ante costs of borrowing.

The observation that imposing high ex post renegotiation costs can impose valuable discipline on a borrower is well taken. But this insight assumes that borrowers will respond to these incentives by choosing a level of debt that optimally balances the debtor's ex ante borrowing costs with its ex post costs of financial distress. Sovereign debtors, by contrast, often have built-in incentives to commit themselves to excessively high restructuring costs, rather than optimal ones.<sup>14</sup> In part, these incentives are political. Political leaders are more concerned about short-term issues such as how much they can borrow rather than long-term ramifications such as the potential consequences of default since the current administration will usually be gone by the time any repayment difficulties arise. Somewhat similarly, current leaders may borrow to further their own goals even if the effect is to impose inordinate restructuring costs on the country as a whole. In addition to these political considerations, sovereign debtors who are good credit risks may agree to excessive restructuring costs for signaling purposes, to indicate that they are unlikely to default. The creditors of a sovereign debtor may be similarly anxious for the debtor to, like Ulysses, bind itself to the mast, because high restructuring costs can serve as a form of implicit

priority vis-à-vis debt that is less difficult to restructure. Finally, the fact that excessive restructuring costs increase the likelihood of a bailout in the event of financial distress may give the parties another reason to gravitate toward debt that is too difficult to restructure.

Putting large barriers in the way of restructuring, as current sovereign debt practice does, has important downsides even before any default. Because it is difficult to establish enforceable priorities in sovereign debt, creditors adjust by insisting on priority substitutes such as a rapid repayment schedule.<sup>15</sup> Inefficiently short maturities can create a rollover crisis when the debt comes due, and the crisis is likely to be exacerbated if there are significant impediments to restructuring.

In sum, although the prospect of high restructuring costs can have beneficial ex ante effects, it is not likely to work well in the sovereign debt context. Sovereign debtors have too great an incentive to include excessively stringent limitations on restructuring. A better approach must provide more flexibility to restructure the sovereign debtor's obligations in the event of financial distress. It must consider the ex post costs of financial distress, such as the perverse effects of debt overhang in the event debt cannot be restructured, rather than just the ex ante costs.

### **Can Majority Voting Provisions Solve the Problem?**

The other major alternative to sovereign bankruptcy assumes just this: that sovereign debtors need the flexibility to restructure their debt if they face a financial crisis. Rather than a full-blown SDRM, however, proponents of this view argue that existing bond contracts—perhaps with a few modifications—are fully adequate to the task. The silver bullet, in their view, is to use majority voting provisions (also known as CACs) to restructure troubled sovereign debt. These clauses provide that, if a specified majority, often 75 percent, of the bondholders vote to restructure the payment terms of the debt, all of the holders of the bonds in question are bound by the vote. Sovereign debtors already include majority voting provisions in debt they issue under U.K. law—roughly 40 percent of all sovereign debt<sup>16</sup>—and they already have been used in a few cases to restructure sovereign



debt. Majority voting advocates argue that, if sovereigns included these provisions in all of their debt, CACs could provide most or all of the benefits of sovereign bankruptcy and sidestep the political and administrative obstacles to putting a bankruptcy framework in place.<sup>17</sup>

We should emphasize from the beginning that we share some of the enthusiasm for majority voting provisions. To the extent that CACs enhance the prospects for restructuring, they are an improvement over the unanimous action strictures that have traditionally characterized sovereign debt issued under U.S. law. Moreover, the most elegant defenders of the CAC approach have emphasized that its chief advantages over an SDRM are pragmatic rather than theoretical. CACs are a solution that is well within our grasp, they argue, whereas SDRMs are not.<sup>18</sup> Even if every sovereign debt issue included a CAC,<sup>19</sup> however, there are at least four serious limitations that make the majority voting strategy a poor substitute for sovereign bankruptcy.

The first limitation is that majority voting provisions do not provide for a sufficiently comprehensive restructuring. It is not accidental that the sovereign debtors that have used these provisions to restructure their debt have tended to be small countries with a relatively simple debt profile. Majority voting provisions can work fine if the sovereign has only issued a few different bonds, but the bond-by-bond restructuring strategy is much less effective if there are numerous different bonds, with different maturities and payout terms, to deal with. Moreover, this approach does not provide any mechanism for addressing the sovereign's nonbond debt. In short, CACs are only adequate to the task if the sovereign's borrowings are relatively simple; they are much less useful if the sovereign has a more complicated debt profile.

The historical antecedents of Chapter 11, the U.S. provisions for corporate restructuring, provide a useful illustration of this point. The early U.S. reorganizations known as "equity receiverships" involved the nation's railroads, which had unusually convoluted capital structures. When the reorganizers restructured the railroads, they did not simply restructure the bonds one issue at a time. Rather, the bankers and lawyers formed committees for each class of public stock or debt,

negotiated the terms of a restructuring not just for these claimants but for other debt holders as well, and then formed a single supercommittee to effect the reorganization.<sup>20</sup> The actions of individual committees alone would not have sufficed to sort out the financial chaos.<sup>21</sup> Sovereign borrowers need a similarly comprehensive solution to financial distress.

The second problem with CACs is closely related: not only does majority voting fail to provide a comprehensive solution to financial distress, but it also will often leave the sovereign with too much debt.<sup>22</sup> Creditors will trade off the efficiency benefits of debt reductions against the costs in terms of reduced expected debt repayments; as a result, a debt restructuring procedure that is too creditor-friendly may result in inefficiently low debt forgiveness.<sup>23</sup> By contrast, statutory bankruptcy regimes can be adjusted to be more debtor-friendly if this kind of inefficiency is a concern.

Less often recognized, but crucially important, is a third limitation of CACs: the danger that they will undermine absolute priority. Even under the best of conditions, establishing priority and achieving the efficiency benefits of this differentiation are quite difficult in the sovereign debt context. It is harder for sovereigns than for corporate debtors to offer collateral, for instance, and enforcement is quite tricky when the debt does purport to provide security. As a substitute for collateral, sovereigns have relied on differential repayment schedules and implicit priorities. If debt restructuring is left to the market, there is no clear way to guarantee that the parties' agreed-on priorities will actually be respected if the sovereign encounters financial distress. As noted earlier, the restructuring of Ecuador's debt in 1999 is a good illustration.<sup>24</sup> Although some of Ecuador's Brady bonds were collateralized and thought to have priority, these bonds were actually restructured first, prior to Ecuador's noncollateralized Brady bonds.<sup>25</sup> The restructuring thus turned the bonds' ostensible priority scheme on its head.

A final shortcoming of majority voting is that it does not address the sovereign's need for new financing. An essential part of U.S. corporate reorganization practice is the possibility of obtaining debtor-in-possession financing to preserve the going-concern value of the firm. If anything, DIP financing may be even more critical for

sovereigns because of their vulnerability to capital flight and exchange rate crises. The IMF's pattern of lending into arrears serves a similar function, but the IMF has not tied its lending to the negotiation of a restructuring agreement between the sovereign and its creditors. As a result, the IMF's lending often has the perverse effect of encouraging creditors to drag their feet, delaying restructuring negotiations in the hope that the IMF will step in and provide new money.<sup>26</sup>

Rather than relying on the IMF, majority voting advocates have argued that bondholders can coordinate among themselves to facilitate DIP financing. If new lending on a priority basis will solve the sovereign's underinvestment problem, they argue, all of the creditors will be better off if they vote to subordinate their own interests in favor of the new lender.<sup>27</sup> But this strategy suffers from several of the same limitations that we have already seen. If the sovereign's debt structure is at all complex, coordinating all of the bonds and holding a vote to pave the way for new financing would be complicated and often unworkable. Moreover, the financing would be further undermined by the difficulty of guaranteeing that the new lender's priority would be honored if the sovereign experienced further financial difficulties down the road.

There are a variety of ways one could structure the DIP financing provisions in an SDRM, and we will explore the alternatives in detail later in the discussion. The important point for present purposes is that majority voting provisions do not provide a workable solution to the problem of securing financing during the restructuring process. We should emphasize that this does not mean that policymakers should discourage sovereigns from including CACs in their bonds. Even if an SDRM were adopted, some sovereigns could still use majority voting provisions to restructure their obligations outside of the SDRM, just as some corporations restructure their debt outside of Chapter 11 or other formal insolvency provisions. But, in many sovereign debt crises, CACs are not an adequate substitute for a full-blown SDRM.

## **Half a Loaf: The IMF's Proposed Bankruptcy Framework**

The most important development since Anne Krueger put forward the idea of an SDRM, thus signaling the IMF's commitment to that approach, is the more detailed draft proposal outlined by the IMF staff in late 2002, and further adjusted in February 2003.<sup>28</sup> The discussion that follows will provide a brief, critical assessment of the key attributes of the IMF proposal. This discussion will set the stage for our own proposal, to be developed later in the discussion.

From our viewpoint, the most notable thing about the proposal is the important inspiration it draws from corporate bankruptcy principles and practice.<sup>29</sup> The general principles underlying the IMF's proposal are the same as those generally advocated by legal scholars and economists for corporate bankruptcy. In particular, the IMF purports to go beyond existing contractual solutions and attempts to set up a comprehensive statutory approach to sovereign debt restructuring.

The IMF's guiding concern is to resolve collective action problems among dispersed creditors in debt restructuring negotiations, while preserving creditor contractual rights as much as possible.<sup>30</sup> Viewed from this perspective, the key element in the IMF's proposed mechanism is a majority vote among creditors on a restructuring plan, which would bind a dissenting minority.<sup>31</sup> With the aim of preserving creditor rights as much as possible, the IMF's plan generally does not envisage a stay on litigation and individual debt collection efforts or a standstill on debt payments.<sup>32</sup> The IMF's main stated justification for not introducing an automatic stay into an SDRM is that sovereign assets are much harder to collect than corporate assets. Lengthy and uncertain litigation may be required and even if the creditor plaintiff prevails, it is likely that a restructuring agreement would already have been approved, which could limit the plaintiff's gain.

The main limitation on plaintiffs' gains envisioned by the IMF is reflected in international insolvency law: the hotchpot rule. This rule requires that any payment or asset collected by a plaintiff through litigation must be offset against the plaintiff's claim in the restructuring agreement.<sup>33</sup> That is, any new claim the plaintiff would

be entitled to in the restructuring agreement would be reduced by an amount equal to what the creditor obtained through legal action. Should the plaintiff obtain more than what the restructuring agreement specifies then the hotchpot rule could be supplemented with a “claw-back” provision. The IMF’s original proposal does not allow for such a provision on the grounds that it would be impractical, but the hotchpot rule was added as a possible option in the final version of the proposal.<sup>34</sup>

The hotchpot rule clearly reduces incentives for private litigation, but it does not eliminate them. Also, it does not directly address the concern that private litigation may be undertaken mainly as a negotiation or delaying tactic, for example, by undermining the sovereign’s ability to trade. The IMF’s proposed plan recognizes this issue by proposing that the judge could have authority to stay specific legal actions on request of the debtor and subject to approval of creditors.

The voting provision and the hotchpot rule are the centerpieces of the IMF’s proposed plan. The plan also contains many more technical provisions dealing with notification of creditors, registration, and verification of claims.<sup>35</sup> As in corporate bankruptcy this can be a lengthy and difficult process. An important additional complication is that the ultimate ownership of a sovereign bond is hard to trace. The court must be able to pierce through the veil of beneficial ownership to be able to ascertain whether the votes on a particular bond are controlled by the sovereign. Should that be the case, these votes should be ineligible for obvious conflict-of-interest reasons.<sup>36</sup> A related difficulty is that for widely dispersed debt structures, many claims may not be registered in time. Given the large number of claims that will fail to qualify, a requirement that a supermajority of “registered” claims approve the plan may function more like a simple majority requirement in practice, thus resulting in a weaker protection of creditors. These difficulties underscore the need for a court-supervised restructuring procedure as well as the important benefits that might be available with the establishment of an international clearinghouse.

Since the main focus of the IMF's proposed plan is on the resolution of collective action problems among sovereign bondholders, the mechanism is under-inclusive and incomplete on the two other major facets of a restructuring procedure: the provision of priority financing and the enforcement of absolute priority. The plan's only means of enforcing absolute priority is through the exclusion of several classes of debt from the SDRM. Thus, the plan proposes to exclude privileged claims, obligations to international organizations such as the IMF (multilaterals), and debt owed to other nations (the Paris Club). A first difficulty with this approach is that it implicitly recognizes a higher priority to Paris Club debt as a *fait accompli* and singles out by default private investors as the main target for debt reduction. This difficulty is compounded by the discretion given to the debtor under the plan to include or exclude debt claims, such as trade credit, claims on the central bank, and the like, from the SDRM.<sup>37</sup> Again, this discretion gives the debtor considerable power to undermine a given priority structure and to cut side deals with particular creditor classes in exchange for an exclusion of the claims from the formal SDRM proceedings. Yet another difficulty is that the plan does not address collective action problems among privileged claimholders, nor does it deal with the incentives of individual bondholders to obtain a lien on an asset through private litigation during the debt restructuring phase.

The plan recognizes some of these difficulties and proposes as an alternative to include Paris Club debt in the SDRM under a separate class.<sup>38</sup> The plan also allows for other forms of classification and gives the debtor discretion to classify under the general requirement that classification does not result in "unjustified discrimination of creditor groups."<sup>39</sup> While classification brings about greater flexibility, it is important to understand that it does not guarantee in any way enforcement of absolute priority. To the contrary, as currently structured, the IMF's plan may well facilitate deviations from absolute priority by giving a veto power, unconstrained by a cram down or best interest rule, to a junior creditor class.

Just as the IMF's plan does not systematically address the issue of enforcing absolute priority it does not adequately address the issue of DIP financing. Again, with the objective of preserving creditor contractual rights as much as possible, the IMF's proposed plan only

allows for “priority financing” if it is approved by “75 percent of outstanding principal of registered claims.”<sup>40</sup> The main purpose of DIP financing is to address an immediate cash crisis and allow the debtor to function while the restructuring negotiations are ongoing.<sup>41</sup> Clearly, a creditor vote would be extremely difficult to organize in a timely fashion, making it virtually impossible to organize any such financing.

The last key component of the IMF’s plan is its proposal to set up an independent Sovereign Debt Dispute Resolution Forum (SDDRF) to oversee the sovereign bankruptcy process.<sup>42</sup> The selection of judges to be appointed to the SDDRF would be delegated to a selection panel designated by the IMF’s Managing Director and charged with the task of making up a short list of candidate judges who might be impaneled when a debt crisis arises. The final short list would be subject to approval of the IMF’s governing board. The president of the SDDRF would be charged with the selection of the final group of four judges to be impaneled in the event of a crisis. While the plan goes to considerable lengths to guarantee the independence of the SDDRF, it is still worth noting that this procedure is not a foolproof method to guarantee such independence.

The court would have more limited powers than a bankruptcy court in the United States. Its powers would be limited to the registration of claims, supervision of the voting, and the final certification of the agreements. In addition, the court would have the power to resolve disputes and to grant injunctive relief subject to the creditors’ approval. These are very limited powers, which do not include important powers of U.S. bankruptcy judges such as the power to subpoena and the power to impose sanctions on parties acting in bad faith during the restructuring process. Nevertheless, the SDDRF does have some important powers, such as the authority to exclude evidence and to terminate the process. These powers could be sufficient to enable the court to supervise the restructuring process effectively.

Overall, the IMF plan is an extremely important development in our thinking about how best to address sovereign debt crises. As this brief overview makes clear, however, it also has a variety of limitations. Most important, the IMF plan focuses extensively on the

ex post issue of solving creditors' collective action problems, but it pays much less attention to the equally important issue of the ex ante effects of an SDRM, particularly, the need to honor creditors' priorities in order to facilitate sovereign credit markets. As we outline our proposal in the discussion that follows, we will place particular emphasis on the possibility of using an SDRM not only to solve creditors' collective action problems, but also to promote absolute priority. We also propose a less cumbersome approach to interim financing and call for a very different SDRM decision maker—existing bankruptcy and insolvency courts, rather than an international organization.

### **The Need for a Stay on Enforcement**

Having shown the need for a sovereign bankruptcy framework and briefly describing the IMF's proposed SDRM, we now turn to the more complex task of developing our own proposal. This section begins the analysis by considering whether the SDRM should include a stay on creditors' enforcement activities. After arguing for at least a limited stay, we conclude by briefly addressing the related issue of whether the initiation of sovereign bankruptcy should be voluntary (that is, by the sovereign), involuntary (by creditors), or a combination of the two.

### **The Choice Among Automatic, Conditional, or No Stay**

An important function of bankruptcy is to solve creditors' coordination problems. Indeed, this arguably is bankruptcy's most important ex post function. (Protecting creditors' priorities is, as we have emphasized, the most important ex ante objective.)<sup>43</sup> Bankruptcy enables the debtor's creditors, who may be numerous and widely scattered, to come together and develop a collective response to the debtor's financial distress.<sup>44</sup> With ordinary corporate debtors, lawmakers have long worried that creditors may try to sidestep the collective proceeding, and engage in a "race to the courthouse" or "grab race" in an effort to get their money back before anyone else gets paid. Although this strategy is rational for individual creditors, it can destroy value by, for instance, forcing the piecemeal liquidation of assets that would be worth more as a going concern.



U.S. bankruptcy law addresses the grab race concern by providing for an “automatic stay” of creditors’ collection activities.<sup>45</sup> From the moment a debtor (or its creditors) files for bankruptcy, creditors must cease and desist from all of their collection activities—no more litigation, no execution on liens, no more angry letters to the debtor’s managers. In other nations, the stay is more limited. In England, for instance, secured creditors are not stayed<sup>46</sup> and some bankruptcy systems omit the stay altogether.<sup>47</sup>

The debate as to whether sovereign bankruptcy should include a U.S.-style stay, a lesser stay, or no stay has focused on a crucial distinction between sovereigns and ordinary corporate debtors: it is much harder for creditors to enforce their interests against sovereigns. The sovereign’s local assets usually cannot be seized, and most sovereign assets are within the country, which significantly limits a creditor’s enforcement options if the sovereign defaults. Some commentators have argued that the obstacles obviate the need for a stay altogether. The “State’s unilateral decision to suspend payments would produce virtually the same effect as a stay,” according to one commentator.<sup>48</sup> Not only are stays unnecessary, according to this view, but the stay would “likely generate significant litigation on issues including when the stay should apply, when it should end, and what exceptions should be allowed.”<sup>49</sup> Based on similar reasoning, as well as creditors’ opposition to the inclusion of the stay, the IMF does not call for a stay in its most recent SDRM proposal.<sup>50</sup>

Although we agree that the stay is less critical for sovereign debtors than for ordinary corporations, it is important not to overstate the distinctions. Sovereign debtors may be vulnerable to asset seizures by determined creditors, for instance.<sup>51</sup> Consider a sovereign that has a state-run airline, as many do. If the sovereign defaulted, creditors could seek to attach the sovereign’s airplanes after they landed in a country that permitted such actions. In recent years, the sovereign finance community has watched rogue creditors act precisely this way, pouncing on vulnerable assets.<sup>52</sup> Given the amount of money on the table, there is every reason to believe that creditors will continue to devise strategies for collecting their debts if given the opportunity. These risks suggest that it may be important to have at least a limited stay as part of the SDRM.

Rather than eschewing the stay altogether, some commentators have called for an intermediate, scaled-down version of the stay.<sup>53</sup> Proponents of this view acknowledge the need for a stay in many cases, but they argue the stay should not be automatic; rather, it should be conditioned on a majority vote of the sovereign's creditors.<sup>54</sup> Under this approach, if a sovereign defaults and initiates a restructuring effort under the SDRM, and one or more creditors continue to pursue litigation or other enforcement strategies, another creditor could propose that these enforcement activities be stayed. The request for a stay would trigger a referendum on the proposed stay. If a majority of the sovereign's creditors voted in favor, the stay would go into effect; otherwise, creditors would remain free to attempt to collect the amounts owed to them. Either way, the creditors would negotiate with the sovereign over the terms of a restructuring plan that would then be put to a vote.

It is easy to see why proponents of the conditional stay might find this approach attractive. If the sovereign's debt structure is quite simple, for instance, its creditors might see no need to impose a stay. (Ideally, in this view, no one would even propose a stay; but if they did, the remaining creditors would vote it down.) The prospect of eschewing stays in at least some cases would reduce the intrusiveness of the bankruptcy process. There would be no need to fight about the parameters of the stay, and the restructuring process could proceed in much the same way as it does in the absence of an SDRM.

Unfortunately, creditor votes are too cumbersome to ensure a timely stay if one were needed.<sup>55</sup> The vote on the stay would not take place immediately. To the contrary, it would take weeks and possibly several months to determine who all of the sovereign's creditors are, provide notice, and collect votes on a proposed stay. There is a serious risk that delaying the stay this long would amount to closing the barn door after the horses escaped. During the weeks or months before the stay was finally issued, vigilant creditors could try to seize airplanes, or, as in the *Elliott Associates* case, attach funds in transit.<sup>56</sup>

Rather than using a creditor vote, a better strategy would be to adopt a targeted stay, which would differentiate between ordinary litigation, on the one hand, and the actual seizure of assets on the other. Because ordinary litigation is unlikely to interfere with the

restructuring process,<sup>57</sup> a targeted stay could apply solely to asset seizures. Efforts to obtain assets (whether tangible assets or financial assets such as bank accounts) could be stayed, while the litigation process (up to the point of enforcement through asset seizure) would be permitted to go forward. A targeted stay of this sort would be much less intrusive than a sweeping standstill, yet it would prevent the most troublesome interferences with an SDRM.

An important issue raised by this limited stay concerns the status of a creditor who litigates to enforce its claim and obtains a judgment, but is prevented from enforcing its judgment by the stay. Does this creditor have an enforceable property interest in some or all of the sovereign debtor's attachable assets, such as airplanes located in the jurisdiction of the judgment? Our view is that any judgment obtained *after* the initiation of the SDRM should not give the creditor a property interest unless the restructuring effort later fails. A creditor that obtains a lien or other property interest prior to the initiation of the SDRM would be entitled to a priority interest in any assets covered by the lien, but creditors who obtained a lien during the restructuring process would continue to be treated as general unsecured creditors for the purposes of the restructuring process.<sup>58</sup> Only if the SDRM proceeding were later dismissed would a creditor be treated as a priority creditor and permitted to enforce its property interest. At least at the margin, preventing creditors from parlaying their postfiling collection efforts into an enforceable ownership interest would diminish their incentive to circumvent the bankruptcy proceeding in order to obtain full payment of what they are owed.

Let us suggest one additional alternative that could achieve many of the same benefits as our proposed limited stay. Rather than an automatic stay of asset seizures, the SDRM could include a right of appeal from judgments received by a creditor after the SDRM was underway. With judgments that threatened to undermine the restructuring process, the court could impose a stay; otherwise, the court would simply permit the creditor to pursue its remedies.

The most obvious concern with an appeal strategy is that creditor enforcement activities could interfere with the sovereign's restructuring efforts during the period before the appeal. Even a temporary seizure of sovereign assets could have substantial

untoward effects. A second, quite different concern is that the appellate process seems to put the court in the awkward position of passing judgment on the courts of the country where the assets are located. An important mitigating factor with respect to the sovereignty concern is that the SDRM court would not need to address the merits of the decision made by a nation's judicial system. Rather than second-guessing the validity of the decision in question, the SDRM court would simply be determining whether a stay is necessary to protect the restructuring process.

Overall, we can imagine an SDRM working effectively even without a formal stay. The stay (with the exception of the need for some kind of capital controls, as we discuss briefly below) is not as essential as the other provisions we will be discussing, such as interim financing. Ideally, however, the SDRM would include at least a limited stay. A stay on asset seizures would prevent the kinds of interventions by rogue creditors that have interfered with several restructuring efforts in recent years. Providing for an appeal from judgments that threatened to interfere with the restructure might have a similar effect.

Throughout this discussion, we have focused on traditional collection activities by creditors. Before moving on, we should note that sovereign debtors face another, somewhat analogous threat as well: the risk of a run on the sovereign's currency. In the face of a debt crisis, investors may withdraw their money from the troubled nation, which can then magnify the sovereign's fiscal crisis. The threat of a currency crisis can sometimes be addressed by capital controls, which function somewhat like the more traditional stay we have described.<sup>59</sup> Capital controls, however, are also fraught with difficulties.

In the past, they have often been evaded, and it is very difficult to prevent currency runs from occurring as soon as the controls are lifted. Because capital controls are beyond the scope of our inquiry—which concerns the structure of an international bankruptcy framework—we do not take a position on whether or how capital controls could be used to protect against the risk of currency runs. But it is important to note both that capital controls are another significant issue when sovereigns face a debt crisis, and that capital controls

could be implemented in tandem with the sovereign bankruptcy framework we propose.

### **A Note on Initiation: Should Involuntary Bankruptcy Be Permitted?**

All of the existing sovereign bankruptcy proposals either assume or explicitly state that the sovereign debtor should be the one to initiate the restructuring process.<sup>60</sup> Like the most closely analogous regime, the U.S. provisions providing for municipal bankruptcy, and unlike the corporate bankruptcy laws of most nations, these proposals would not permit a sovereign debtor's creditors to trigger the restructuring process involuntarily. This voluntary-only limitation is grounded in sovereignty concerns. Advocates of the voluntary-only approach point out that the private creditors' ability to throw a sovereign debtor into bankruptcy could be seen as interfering with the sovereign's autonomy.<sup>61</sup> They also worry that the sovereign's creditors might use involuntary bankruptcy strategically, invoking bankruptcy for political rather than economic reasons.

Notwithstanding these concerns, there is greater merit in recommending involuntary bankruptcy than is often appreciated. Under a voluntary-only regime, sovereigns may file for bankruptcy much later than the optimal time. This seems counterintuitive, because commentators often identify moral hazard—the concern that sovereigns will invoke the SDRM opportunistically—as an important downside of sovereign bankruptcy. In practice, however, sovereigns seem to default too late, not too early, due both to the reputational consequences of default, and to their ability to issue new debt, which dilutes the existing stock of outstanding debt and postpones the day of reckoning. Creditor initiation could serve as a corrective, counteracting both the reputational and the overborrowing concerns. Creditor initiation would alleviate the sovereign's reputational concerns by suggesting that the filing really was necessary—that is, the sovereign was not trying to use bankruptcy opportunistically.<sup>62</sup> With respect to overborrowing, involuntary initiation would provide a mechanism for creditors to block new debt issues that threaten to dilute their debt. In effect, involuntary initiation could serve as a substitute for dependable enforcement of priorities outside of the SDRM. Not only would this ensure a more timely initiation of the

SDRM, but, by protecting creditors' priorities, it also could significantly enhance the functioning of sovereign credit markets *ex ante*.

Now, an obvious concern with creditor initiation is that one or a small group of rogue creditors might initiate the SDRM opportunistically. The simplest solution is to require that a critical mass of creditors sign on to any involuntary SDRM petition. If the provision included a requirement that at least 5 percent of the sovereign's creditors participate in any petition, the risk of frivolous filings would largely disappear.<sup>63</sup> The requirement could be further refined by excluding creditors whose debts are not yet in default from participating in the involuntary petition.

Whether sovereign debtors would agree to an SDRM that could be invoked involuntarily, by the sovereign's creditors, is of course an open question. It is important to note, in this regard, that sovereigns are already subject to suit in foreign courts, and have been since they began waiving sovereign immunity in the 1970s.<sup>64</sup> Moreover, creditor initiation would help to offset the perception that sovereign bankruptcy is too lenient on sovereign debtors. In short, from the perspective of both creditors and sovereign debtors, involuntary bankruptcy makes much more sense than is generally thought.

### **Classification and Voting**

Besides helping to resolve collective action problems among creditors, the other important function of bankruptcy is to enforce priority of senior claims over junior ones. This is also an important potential role for the SDRM. It is even more so given that it is currently very difficult to enforce a priority claim on a sovereign. With the exception of a small fraction of privileged claims, issued mostly by public entities separate from the sovereign, it is generally impossible for a private creditor to enforce a priority payment. Even if a subordination clause were included in a sovereign bond issue, it would be essentially unenforceable. As a result, enforcement of absolute priority under the SDRM may have even more important effects than enforcement of priority under corporate bankruptcy.<sup>65</sup>

We begin our discussion of classification and enforcement of absolute priority with an illustrative example showing how, in the absence of any enforcement of priority, early creditors are exposed to a risk of dilution of their claim by subsequent debt issues of the sovereign. The example shows how the possibility of dilution gives rise to a “soft budget constraint”<sup>66</sup> for the sovereign, delayed debt restructuring, overborrowing, and higher costs of debt.

### **Example: Debt Dilution and Overborrowing**

Consider the following situation involving a sovereign borrower. The country borrows 100 to undertake an infrastructure investment in year  $t = 0$ . In normal circumstances this investment is expected to produce a yearly flow return of 20 in present-discounted (tax) revenues over a period of 10 years, starting in year  $t = 1$ . In other words, the cumulative present-discounted return over the 10 years is 200. But, in the event of a crisis, an adverse macroeconomic shock, a currency attack, or a political crisis, the maximum present-discounted yearly revenues that can be transferred to creditors are expected to drop to 5. We shall take it that this negative shock may occur in year  $t = 1$ . If it arises it reduces the sovereign’s revenues in year  $t = 1$  and all remaining years. Moreover, we shall suppose that these revenues are obtained only if in the event of a crisis the debtor undertakes prompt corrective action by restructuring its outstanding debt obligations immediately. If the sovereign postpones restructuring, then the present-discounted yearly revenues will only be 4 over the next 10 periods.

The idea here is that if prompt restructuring is accompanied by immediate new infrastructure investments or more fiscal austerity measures, they will enhance the sovereign’s capacity to repay its debts. However, if restructuring is delayed, these measures or new investments will also be delayed, leading to lower potential repayments over a decade.

For simplicity we shall suppose that a negative shock is expected to hit the sovereign in year  $t = 1$  with a 50 percent probability. Consider first the situation where the sovereign can borrow only from one source: a single large, risk-neutral lender issuing a single long-term debt claim. This lender is willing to lend as long as it expects to break

even. Under prompt corrective action, this lender can expect to get a present-value return of 50 in the event of a negative shock, so that the minimum face value of the debt at which the lender can expect to break even at the time of issuance will be  $D_0 = 150$ , with a specified total yearly repayment of 15 over the 10-year period. Indeed, with probability 0.5 the sovereign will not be hit by an adverse shock, the lender will then receive a flow return of 15 over 10 periods amounting to a present-discounted value of 150. But with probability 0.5 a bad shock hits the sovereign, the debtor will be unable to meet the flow interest payments of 15.

What happens then? Since there is only one lender to whom the sovereign can turn, the sovereign is unable to raise new funds from other sources in an attempt to meet the outstanding debt obligations to the lender. The only option open to the sovereign then is to try to reschedule or roll over the lender's debt obligation. But this is a decision for the lender to make. If the lender is unwilling to roll over the debt the sovereign will be forced to default. In other words, the sovereign will be in the hands of the lender and will be forced to restructure its fiscal position and outstanding debt promptly when an adverse macroeconomic shock occurs. The lender will agree to a debt reduction as long as the sovereign commits to undertaking the desired corrective actions and agrees to repay a yearly payment of 5 over the 10 periods.

These repayments add up to a total present-discounted repayment of 50. Thus, in expected terms the lender will get a total repayment of  $[0.5 \times 150 + 0.5 \times 50] = 100$ , just enough to cover the initial outlay of 100.

Thus, in the presence of a single lender the sovereign can raise 100 by issuing a total debt with face value of 150 and yearly repayments of 15. The sovereign faces a "hard budget constraint"<sup>67</sup> in the sense that it is unable to borrow itself out of a crisis and thereby delay the required restructuring. When a crisis occurs in year  $t = 1$ , the sovereign is forced either to default or to promptly restructure its debts.

But when the sovereign can raise new funds from other creditors and absolute priority is not enforced, it no longer faces a hard budget constraint. To see this, suppose that there is another creditor to which



the sovereign can turn in year  $t = 1$ . Suppose in addition that the sovereign government always prefers to delay restructuring if it can. This may be the case, for example, if a new administration is taking office every year and there are net private costs involved for the administration in place in undertaking a major fiscal restructuring effort. Then each administration in office would prefer to have a later administration deal with the problem. Although incentives for procrastination are put in a very stark way in this example, this is hardly an unrealistic description of the behavior of many governments that have let their debt balloon rather than taking prompt corrective action in response to an adverse economic shock.

When there is a single potential lender available, it is not feasible to delay the restructuring, as we have explained above. It has to be dealt with immediately. In other words, the single lender acts as a commitment device for fiscal discipline. But when the sovereign can borrow from another source (at competitive terms) and priority is not enforced, then the sovereign may well be able to borrow itself out of the crisis and postpone restructuring. As a result, the low cost of borrowing under a single exclusive lending relationship is no longer obtainable.

To see this, suppose by contradiction that a naïve initial lender is willing to lend 100 in year  $t = 0$  in exchange for a face value claim of 150, with a required flow repayment of 15 over 10 periods. Further, consider what the sovereign would do in response to an adverse shock in year  $t = 1$  when no subordination priorities or other covenant protections are enforceable in international debt markets, as is currently the case. Then, in the event of a bad shock in year  $t = 1$ , the sovereign will be able to postpone corrective action for at least one period by issuing new debt, which *dilutes* the old outstanding debt.

To be able to meet the required debt repayment of 15 in year  $t = 1$  following an adverse shock, the sovereign needs to raise 11 from another source. Indeed, if the sovereign fails to restructure and take prompt corrective action it will generate yearly revenues of at most 4.

What is the face value of this new debt? Put differently, how much is a new debt claim of  $D_N$  with flow repayment  $d_N$  over nine periods worth in the market? Under current *pari passu* rules the new debt will receive a fraction  $[d_N / (d_N + 15)]$  of the yearly flow revenue

of 4 following restructuring in period  $t = 2$ . Therefore, the promised new repayment  $d_N$  is worth

$$4 \times [d_N / (d_N + 15)] = [4 d_N / (d_N + 15)].$$

The sovereign, therefore, only needs to set  $d_N$  at a level such that:

$$9 \times [4 d_N / (d_N + 15)] = 11.$$

This figure is the amount of new funds the sovereign needs to raise to be able to meet its old debt obligations and postpone corrective action until the next period. In sum, any new debt with a promised yearly repayment of  $d_N = 33/5 = 6.6$  will do the trick!

A central conclusion of this example is that this new debt issue involves a significant dilution of the value of the old debt claim. Instead of receiving a flow repayment of 5 over 10 periods in the event of a bad shock the initial lender now receives at most 15 in year  $t = 1$  (as the sovereign fully meets the required debt repayment in an attempt to postpone the painful debt restructuring) plus 25 (that is,  $9 \times 4 - 11$ ) in the subsequent nine years. That is a total of 40 instead of the previous 50 (when there was no dilution and prompt corrective action).

How much does this risk of dilution affect the cost of borrowing of the sovereign when dilution is anticipated at  $t = 0$ ? To be able to answer this question one needs to determine the sovereign's total capacity to raise new debt in the event of a negative shock. For any initial outstanding debt  $D_0$  the sovereign will be able to raise at most 40 if the new lenders lend on fair terms, given that restructuring does not occur in year  $t = 1$ . In an attempt to avoid default and thus postpone restructuring as much as possible the sovereign will actually pay out this entire amount to the old lender.

Therefore, when overborrowing is expected in response to an adverse shock, which then dilutes outstanding debt, the face value of the original debt must increase from  $D_0 = 150$  (with no dilution) to  $D_0 = 160$ . Indeed, by holding a debt claim of  $D_0 = 160$ , with total yearly repayments of 16 over a 10-year period, the initial lender can hope to get

$$0.5 \times 160 + 0.5 \times 40 = 100.$$

Thus, when lending cannot be excluded, the sovereign faces a higher cost of capital and must promise a total present value of repayments of  $D_0 = 160$  (instead of  $D_0 = 150$ ) to be able to raise 100. The efficient outcome with no overborrowing would be attainable if absolute priority were enforced. Indeed, if the initial lender had priority over new lenders, then the sovereign could not turn to new lenders to raise more funds. These junior lenders would not be able to get any repayment following an adverse shock and would therefore be unwilling to lend.

This example starkly illustrates our main argument that the lack of enforcement of absolute priority results in a higher cost of borrowing for the sovereign. It also illustrates how this lack of enforcement of absolute priority may result in overborrowing and inefficiently delayed restructuring.

As bad as the outcome in the absence of absolute priority is in this example, it is still not the worst possible outcome. Indeed, we have only allowed for overborrowing in the event of a negative shock. But incentives to overborrow are present even when no negative shock occurs. Although in theory the sovereign would always want to issue new debt and dilute all outstanding debt, in our example it is not very plausible that sovereigns would pursue a systematic dilution policy with such guile. This is why we have only allowed for such lending in the event of a bad shock.

Under the current international financial architecture, the only lender that imposes discipline on sovereigns and induces them to undertake painful corrective measures to redress their financial health is the IMF. But the IMF is in a weak position to effectively fulfill this role, as has been argued in many places and is widely recognized.<sup>68</sup>

Another important inefficiency that may result from the absence of legal enforcement of absolute priority is that lenders may attempt to obtain de facto priority repayment by issuing “dangerous” debt with short maturity and highly dispersed claimholders, which expose the sovereign to both a higher risk of a debt crisis and higher restructuring costs.<sup>69</sup> Thus, as has been widely recognized by legal scholars of corporate bankruptcy, enforcement of absolute priority is likely to provide a major benefit in sovereign debt markets,<sup>70</sup> and the

introduction of the SDRM provides an ideal opportunity to lay the foundations of a new legal regime of sovereign debt priorities. The question, however, is how to achieve this.

### **Classification, Voting, and the First-in-Time Principle**

To determine how best to protect creditors' priorities in the sovereign debt context, it is natural to first briefly inquire how priority is enforced for corporate debt. An important and widely used way of guaranteeing priority for corporate debt in liquidation is to secure a loan with collateral and to perfect the security.<sup>71</sup> In such a case, the secured creditor becomes the sole owner of the collateral in liquidation. Unfortunately, this option is generally unavailable for sovereign debt.

Another less commonly used option is to insert a subordination clause in the debt contract requiring all subsequent debt to be subordinated. The difficulty with this approach lies in the enforcement of this subordination clause, as it contractually binds only the creditor and debtor who sign the contract. Should the debtor issue future debt with higher or equal priority without the knowledge of the initial lender and should the debtor go bankrupt, the initial lender may be unable to enforce its priority claim. To be able to effectively enforce a subordination clause, the initial lender then needs to continuously monitor the debtor and stop the debtor from issuing new equal or higher priority debt by filing an injunction.

In Chapter 11, secured creditors' actions to appropriate their collateralized assets are stayed.<sup>72</sup> Although commentators have long suspected that secured creditors are not fully protected in Chapter 11, the bankruptcy laws provide a variety of protections designed to ensure that secured creditors' priority is respected.<sup>73</sup> In the Chapter 11 plan confirmation process, absolute priority is enforced by a combination of three elements: (1) classification of secured and unsecured creditors in separate classes,<sup>74</sup> (2) veto power of each class over the proposed restructuring plan,<sup>75</sup> and (3) the "best interest" and "cram-down" rules.<sup>76</sup>

Each of these elements is essential to enforce absolute priority. To see why classification by priority together with a unanimity requirement across classes is necessary to enforce absolute priority, consider the hypothetical rule under which only a (super)majority requirement across classes is needed to approve a plan. It is easy to see that in this case the debtor, who has agenda-setting power at least during the first 120 days of the bankruptcy case,<sup>77</sup> can single out one or several classes for special unfair treatment and hope to win approval from the other classes. By playing one class against another, the debtor may thus be able to secure approval by the required majority of classes of a plan that is very favorable to the debtor. But, worst of all, in the absence of any other protection the debtor can get a plan approved that does not respect the priority ranking of the claims in any systematic way. Thus, in the absence of a unanimity rule across classes, basic creditor protections would be undermined by classification, because any form of classification would permit deviations from equal treatment among all creditors and thus make it easier for a majority of creditors to expropriate a minority.

Under the unanimity requirement, each class, and in particular, each class of secured debt holders, has at least the basic protection given by their veto power. Note, however, that this protection by itself does not guarantee enforcement of absolute priority. Indeed, to the extent that junior classes also have a veto right they can block any restructuring agreement that is not to their liking, even if under a strict enforcement of absolute priority they should not be entitled to anything. In other words, junior creditor classes (and shareholders) also sit around the bargaining table and are as critical as any other class in securing an agreement. They are therefore able to extract some concessions in the restructuring negotiations and thereby may violate the priority ranking of claims.

This is why the third element of the cram-down option and best interest protection is essential. Under the cram down, the court can enforce a restructuring plan even if a junior class opposes it, if the court finds the plan to be “fair and equitable,” which includes a requirement that the plan satisfy the absolute priority rule with respect to any dissenting class.<sup>78</sup> That is, the court can approve the plan if it finds either that the dissenting junior class is paid in full, or that no lower priority class will receive anything under the plan. The best

interest rule provides another protection. If the reorganization plan gives less to a class than it would get under liquidation, a unanimous agreement among the creditors in the class is required for the class to approve the plan.<sup>79</sup> The best interest protection and the threat of a cram down are essential for senior creditors to ensure that the restructuring agreement does not deviate too much from absolute priority. While courts have been reluctant to use a cram down in the past,<sup>80</sup> it has become a much more common practice in recent years. Accordingly, deviations from absolute priority are now significantly smaller.<sup>81</sup>

Interestingly, one could envision an extreme form of cram-down procedure, where the court determines by absolute priority the value of the reorganized firm and the allocation of claims on the reorganized firm to creditors. Under such a procedure, there would in principle be no need for a cumbersome classification of claims and a unanimity rule among classes. However, as one can easily imagine, such a procedure is likely to put too heavy a burden on the court's ability to value a reorganized firm. The court is also likely to lack the information required to reliably classify claims by priority. The debtor is in a much better position to determine which claims should be classified together in a separate class. This is presumably why the law gives discretion to the debtor, within limits, to classify similar claims together.<sup>82</sup>

Our proposal for enforcement of absolute priority under the SDRM mirrors some of the key elements of Chapter 11 by taking into account the specific practical difficulties related to sovereign debt. More so than for firms, judges are unlikely to have the expertise to make a reliable determination as to the sustainability of a sovereign's debt. The judge might seek the expert opinion of the IMF, but the IMF's evaluation of the level of debt that is likely to be sustainable may be seen as politically biased. Creditors and the debtor are likely to also retain experts and to produce widely differing estimates, which may not facilitate the judge's task.

This is why we propose to leave the determination of what is a reasonable reduction of a sovereign's overall indebtedness to the collective decision of the creditors in a two-step procedure. Once all debt claims have been identified and classified into priority classes or

separate classes involving a distinctive common interest (like trade credit), we propose to have the following two steps:

(1) First, the sovereign puts an overall debt reduction proposal to a vote of all creditors in a single class, voting in proportion to their individual debt holdings. The majority rule would be specified in such a way as to fairly balance creditor and debtor interests. Although we will argue for a simple majority approach below, a two-thirds majority may seem reasonable, or even the 75 percent requirement used in most CACs for sovereign debt issue in London.<sup>83</sup>

(2) Once a debt reduction has been agreed on, the sovereign would propose a reorganization plan specifying the treatment of each class of claims. Concretely, all creditor classes would vote on the proposed distribution of claims to the different classes. As under Chapter 11, each class would require a supermajority, say of two-thirds, of the face value of the total debt in the class, and unanimity among the classes would be required. Should one class vote against the proposed allocation of new claims then, as in Chapter 11, a cram down could be enforced by allocating claims directly in order of absolute priority.

The first step would serve the purpose of determining a sustainable level of debt for the sovereign and solve the collective action problem among creditors. The second step would be directed toward the enforcement of absolute priority. A number of obvious questions arise concerning this scheme. We discuss each one in detail below.

(a) How will creditors vote? A creditor's vote will depend to a large extent on how high in the priority ranking the creditor's claim is. If the claim is senior, then the creditor would be in favor of a significant haircut, since the cost of the haircut would fall primarily on the more junior debt classes and since the new claim is more likely to be repaid in full if the sovereign's reorganized debt burden is lower. By the same logic, a junior claimholder would be opposed to significant haircuts. For junior claims, the incentive is to maintain the existing level of debt and "gamble for resurrection." Thus, there will be a "pivotal" creditor or creditor class, which will decide the outcome.<sup>84</sup> Any proposed haircut that is higher than what the pivotal creditor wants will be defeated in a vote, and any haircut that is lower

will be approved. The sovereign will then obviously propose the highest possible haircut that is acceptable to the pivotal creditor.

One potential concern with our proposed two-step procedure is that if a large fraction of creditors are junior claimholders they will be able to block any reasonable haircut. Our restructuring procedure would then result in too little debt reduction. The most extreme such situation would be one where all creditors are junior creditors and would therefore be required to give up some of their debt claims. In such a situation, the creditors would only agree to a haircut that is no greater than what they would agree to in a workout. Such a haircut might be too small for the reasons we have already evoked and it might be desirable to build an incentive for junior creditors to accept greater haircuts into the restructuring procedure. One way of building in such an incentive might be to give higher priority status and greater protection against default to the restructured junior debt. Alternatively, in situations where there are several different priority classes, it might be desirable to reduce the power of junior creditors by using a simple majority voting rule in the first round, rather than two-thirds or 75 percent.

(b) What happens when a proposed haircut is rejected in a vote of all creditors? In the event of a negative vote in the first round, it is reasonably straightforward to determine what should be done next. There are two options. One is to terminate the restructuring procedure and force the sovereign and creditors to find a restructuring agreement outside the SDRM through a workout. The other is to let the sovereign and/or creditors put a new haircut to a vote. The first option would serve as a threat to the sovereign to avoid excessively high haircuts. It would also offer added protection to creditors, who could always collectively guarantee that debt restructuring take place outside the SDRM by voting down any restructuring proposal. The second option is clearly more debtor-friendly. It would be justified if debt restructuring outside the SDRM is seen to result in too little debt forgiveness. Which of these two options is more desirable requires a careful balancing of creditor and debtor interests, which we are not in a position to do.



(c) What happens when a proposed allocation of new claims to creditors is rejected by one or more classes in the second round? Here again one could envision one or multiple new proposals by the debtor or creditors being put to a vote. As in Chapter 11, however, eventually this process has to end. We propose that the judges supervising the restructuring proceedings may decide at their own discretion or at the request of a creditor class to initiate a cram-down procedure, whereby the newly reduced stock of debt is allocated on an absolute priority basis.

(d) How is priority determined and how are claims classified? This is by far the most important and difficult issue, and it demands a somewhat more detailed discussion than the ones we have just covered. Two points require examination. The first one is how the contracting parties can define a priority claim. The second is how the different claims are classified. Who has the authority to classify and what should be the underlying principles?

Most lending to sovereigns can only be in the form of unsecured debt.<sup>85</sup> Thus, specifying a separate priority class for only secured debt and for debt issued by multilateral institutions would provide no more than a very limited form of priority enforcement. To enable enforcement of a more comprehensive form of absolute priority structure and to limit dilution of outstanding debt by new debt as much as possible, we would favor a first-in-time rule for unsecured debt. Such a rule would guarantee repayment of debt issued earlier over debt issued later and would come closest to the ideal of guaranteeing maximum protection against dilution through overborrowing, as has been recognized by legal and finance scholars.<sup>86</sup> Concretely, the way this rule would work is that when a sovereign files for debt restructuring under the SDRM, all unsecured debts would be classified by date of issue and earlier issues would have higher priority over later issues.

The priority scheme we envision would operate as a default rule that could be altered by contract. Subordination agreements between classes of creditors would be enforced. In theory, a sovereign that was concerned about the possibility of a subsequent liquidity crisis could include a provision giving it the right to issue a specific amount of priority debt in each of its contracts with current creditors.<sup>87</sup>

If there are many different issues it may be impractical to have a separate class for every date at which an issue was made. To avoid the creation of too many classes, it may then be desirable to require that each class be of a minimum size in value relative to the total value of outstanding debt. Alternatively, another way of limiting the number of classes may be to lump issues within any given fiscal year together in a single class.

There are two other concerns with the first-in-time rule. First, it may impose substantial risk on new lenders, because they would inevitably be at the bottom of the queue unless they are able to obtain some form of security or other privilege. Of course, exposing new lenders to this risk is desirable to the extent that it forces new lenders to make the economically efficient lending decision: whether to lend the marginal dollar or cut the sovereign off from any new lending given that its existing stock of debt has grown too large. However, inefficiencies may arise if it is difficult for the new lenders to determine exactly how indebted the sovereign is. If the sovereign can easily hide or misrepresent its total indebtedness, new lenders may be excessively reluctant to extend a loan for fear of discovering after the fact that the sovereign's stock of debt is much higher than anticipated. Such an inefficiency could be considerably reduced if a global clearinghouse was established to keep a public record of all outstanding sovereign debt, as was proposed at the Monterrey Summit in 2002 by Norway and the Ford Foundation.<sup>88</sup> With such a clearinghouse it would be a simple matter for a new lender to monitor a sovereign's outstanding debt and to make an efficient lending decision under a first-in-time rule.

The other concern with the first-in-time rule is that new lenders may try to leapfrog the priority ranking by either insisting on a privileged claim or by shortening the maturity of their loan so as to be paid back before the other older debt. This is unlikely to be a major problem, because secured lending is generally difficult to obtain. Also, new short-maturity debt involves only a limited form of dilution of outstanding debt. Should creditors be concerned by this form of dilution, they could in principle get protection through covenants specifying lower limits on the maturity of new debt issues. With the exception of trade credit, which generally can only be of very short maturity, it may be desirable to enforce such covenants. Again,

enforcement of such covenants would be considerably facilitated by the existence of a global clearinghouse.

This brings us to our second point on classification of claims into different classes. Classification of claims by priority is easy to understand in theory but difficult to implement in practice. What is worse, there are likely to be important additional considerations besides priority specific to sovereign debt. For example, it seems reasonable to think of Paris Club debt as a separate class. Similarly, multilateral debt and trade credit may belong to a separate class. One might also argue that bank loans ought to be classified separately from mark-to-market bond issues. Within the category of sovereign bonds a case could be made for classifying the bonds by the financial center where they were issued. Indeed, these centers may represent different clienteles with different economic interests.

To the extent that the treasury department of the sovereign government is likely to have the most detailed knowledge of the country's debt structure and the inner working of the different credit markets they tap, it seems reasonable to leave the debtor discretion over classification, but to constrain the debtor's freedom to classify by requiring that only similar claims can be classified within the same class. If there is sufficient ambiguity about how similar claims must be to belong to a given class and if creditors are concerned that the debtor is "gerrymandering," then it should be possible for the creditors to prevent such classification, *ex ante* by including a covenant in the contract that precludes claims that are considered to be different from being classified with other types of debt, and *ex post* by appealing the debtor's proposed classification.

(e) What should be the priority and maturity structure of the new claims? The discussion so far has been cast in terms of substituting a complex existing maturity and priority debt structure with a single new type of claim on the sovereign. While debt restructuring is often an opportunity to considerably simplify the existing debt structure, it is clearly overly simplistic to think of substituting a single new type of claim for all the different types of claims. Our proposal does not depend in any way on such a radical restructuring. Indeed, when it comes to the second stage of allocating new debt claims to the different classes it may be helpful to think of a swap of old claims for

new claims of a similar type, with only possibly a reduced face value and an extended maturity.

### **Interim Financing for the Restructuring Process**

Having discussed the need for a stay and how the sovereign bankruptcy voting rules should be structured, we turn now to the issue of interim financing. Once again, corporate bankruptcy experience will provide several useful analogies as we develop a framework for the sovereign bankruptcy context.

For corporate debtors, access to interim financing is a crucial determinant of the outcome of the restructuring process. Corporate debtors are nearly always starved for cash when they file for bankruptcy. Both intuition and empirical evidence suggest that those with access to interim financing are much more likely to reorganize than those that lack this access.<sup>89</sup> In the United States, lawmakers have provided sweeping protections for interim lenders in order to facilitate this financing. Under § 364 of the Bankruptcy Code, bankruptcy judges are authorized to give a variety of protections to DIP lenders, including a superpriority lien that gives the DIP lender priority over all of the debtor's other creditors.<sup>90</sup>

Now, to say that the DIP financing provisions are central to the U.S. framework, and that DIP financing encourages a renegotiation of the debtor's obligations, does not necessarily make such a practice desirable for corporate or sovereign bankruptcy. To determine whether DIP financing is desirable and should be adopted, in whole or in part, as part of an SDRM, we must first confront two threshold questions: first, why is a policy that facilitates new borrowing by a distressed debtor required? And second, should a court be left to decide whether to approve priority interim financing?

With corporate debtors, it is not inherently obvious that paving the way to a restructuring is the optimal strategy in the event of financial distress. There may be good reasons for liquidating rather than reorganizing troubled companies. If the company is not viable as a going concern, for instance, reorganization may simply be postponing the inevitable. Moreover, even if DIP financing brings about a more efficient ex post outcome, it is still not obvious that it is

a desirable form of new lending viewed from an *ex ante* perspective. We have argued in the previous section that enforcement of absolute priority is efficient from an *ex ante* perspective.<sup>91</sup> Thus, is there not a contradiction in also contending that DIP financing is an important element of any efficient debt restructuring procedure? After all, the superpriority lien granted to DIP financing involves a violation of the absolute priority rule. So, why make room for DIP financing?

The apparent contradiction between priority lending to facilitate debt restructuring and the absolute priority rule is resolved when one takes into account the collective action problems faced by creditors in any restructuring. Just as it is desirable to prevent a destructive run on the assets following a default, it is also preferable to avoid destructive “free riding” by creditors in granting new funding aimed at reducing the overall costs of the debt crisis. Any new injection of funds can be seen as a new asset that is left up for grabs by other creditors. If the new funding has the same priority as the debt held by existing creditors, some or all of the funding may simply go to paying the existing creditors, thus reducing the likelihood that the new funding will be repaid. Therefore, to ensure that new value-increasing lending is forthcoming, higher priority status must be granted to the new loans. In other words, in the absence of higher priority DIP financing, there may be no new lending even if it is value-increasing because of the “overhang” of existing debt.<sup>92</sup>

The obvious concern with higher priority interim financing is that it also opens the door to value-reducing lending and debt dilution. We can put the same point in terms of under- and overinvestment. When a debtor has a great deal of debt, new lenders will be reluctant to lend because some or all of the new cash will simply subsidize repayment to the existing creditors. Priority treatment of the new loan solves the underinvestment problem—it assures that the new lender gets paid first—but it creates the risk of overinvestment, that is, that the lender, because it is protected, will make the loan even if it should not be made.<sup>93</sup>

In corporate bankruptcy it is up to the court to determine whether the new funding increases the firm’s capacity to meet its existing debt obligations.<sup>94</sup> Under current U.S. bankruptcy practice, bankruptcy courts—following the approach developed in Delaware during the

1990s—generally approve the initial financing immediately, in connection with other so-called “first day orders” that are designed to enable the debtor to keep operating with as little disruption as possible. Delaware bankruptcy judges hold a more formal hearing several weeks later and reserve the authority to withdraw or adjust their approval if they later determine that the terms of the loan are inappropriate.<sup>95</sup> There is often considerable time pressure in evaluating and granting DIP financing. This is why a court’s reputation in handling requests for new DIP financing quickly and efficiently appears to be an important determinant of distressed firms’ decisions on where to file for bankruptcy.<sup>96</sup>

Although debt dilution is an important concern for sovereign debtors, the case for DIP financing to facilitate restructuring by a distressed sovereign is perhaps even stronger than for corporations. Indeed, even more than corporations, sovereigns may require immediate financial backing to stave off a possible run on the currency or the banking system. More generally, privileged lending aimed at reducing the costs of a severe temporary budget crisis and helping the sovereign’s economy to grow out of a recession and thus to meet its future debt obligations is highly desirable. The difficulty lies mainly in devising a procedure for DIP financing that balances the benefits of new lending and the risks of further debt dilution.

Unfortunately, when the debtor is a sovereign rather than a private corporation, it is far less obvious that a court is well situated to rule on DIP financing. Delicate sovereignty issues are involved in giving a court the authority to approve or reject new privileged lending to a government. In addition, even an experienced corporate bankruptcy judge is unlikely to have the expertise required to assess a country’s public finances. To determine whether to approve a proposed financing arrangement, a bankruptcy judge must consider whether the new loan is likely to alleviate a temporary budget or foreign exchange crisis without exacerbating the country’s debt burden. Although the relevant issues, such as the extent of debt overhang, are not entirely outside of the court’s expertise, the bankruptcy judge is likely to be poorly informed about the state of the country’s public finances and the political constraints weighing on government expenditure and taxation. Especially at the outset of the

crisis, when the initial determination is made, bankruptcy judges are likely to have only a limited understanding of the urgency and extent of the sovereign's short-term financial needs. That is not to say that regulation of DIP financing by a court is a clearly unworkable solution. But, before envisioning such a role for courts, it is important to explore whether other perhaps less intrusive alternatives are available.

One alternative to the judge is, as recommended by the recent IMF proposal, to vest decision-making authority in the debtor's creditors.<sup>97</sup> This fits well with the objective of keeping the restructuring process in the hands of the creditors and responds to the concerns about the SDRM's heavy-handedness. It is also likely that at least some of the larger institutional creditors will be better informed about the debtor's financial position and political constraints. In addition, creditors have a direct financial stake in the debtor's fortunes, which gives them a strong incentive to make the right decision. Although this suggests that creditors might make better decision makers, they too face an important limitation: creditors generally are not well coordinated at the outset of the case, which makes creditor decision making difficult when faced with issues that need to be decided early on. With DIP financing, the benefits of a better decision are likely to be overwhelmed by the adverse consequences of waiting to set up a creditor vote.<sup>98</sup>

From this perspective, the U.S. approach is arguably still a defensible compromise. The court is given primary authority, despite its shortcomings, because the judge can make an immediate determination. Before making its decision, however, the court must entertain any objections from creditors, who are better but slower decision makers. To characterize this approach as defensible is not to say that it cannot be improved, however. Given a court's limitations as a decision maker, it is important to consider whether there are ways to channel or constrain its role more effectively. The most sensible strategy, in our view, would be to more carefully distinguish between interim financing that is presumptively enforceable and financing that the court or other decision maker should presumptively prohibit.<sup>99</sup>

As we translate these insights into the sovereign debt context, we need to take one more key issue into account: the role of the IMF. The IMF already functions very much like a DIP lender when sovereigns encounter financial distress. As with most DIP lenders, the IMF usually has worked closely with the sovereign prior to any formal default, and has better information than private creditors about the sovereign's financial status. These informational advantages make the IMF an obvious choice to supply new funds. Moreover, IMF loans, like DIP financing, enjoy priority status, at least in theory. In practice, a strong norm that these loans will not be renegotiated has also worked in favor of the IMF.<sup>100</sup>

There are, however, two major concerns with IMF lending. First and foremost, a central impetus behind policy initiatives to reform the process of sovereign debt restructuring is the recognition that unchecked IMF lending may result in "moral hazard" in lending. Thus, unlike for private sources of DIP financing, the main concern with unchecked IMF lending is not so much that it may dilute the stock of outstanding debt as that it will give rise to too much repayment of existing debt obligations. In other words, the political pressures the IMF is under to extend huge programs to distressed countries and, thus, to bail out the private sector, while helping to alleviate the costs of a debt crisis *ex post*, may only give rise to greater *ex ante* inefficiencies in the form of renewed reckless lending. So, IMF lending needs to be reined in, not to avoid overinvestment and dilution, but to prevent a wasteful bailout.

A second, closely related concern in the case of crisis-prone countries like Argentina is that the perceived priority of IMF loans is an illusion, which persists only as long as IMF loans are being rolled over. Should the IMF thus inadvertently lose its priority status, it would be lending at too favorable terms. This risk gives the IMF an incentive to keep lending even when the lending would not otherwise be justified.

Although the reasons for regulating IMF lending are different from those for regulating private DIP financing, it is interesting to note that the same institution, perhaps a bankruptcy court, could conceivably serve the dual role of keeping both forms of lending in check. In other words, even if this may appear to be a politically



unrealistic idea, it is worth pointing out that an important hidden benefit of delegating the decision to grant DIP financing to an international bankruptcy forum may be that it provides just the kind of institutional commitment power that is needed to credibly restrain the worst temptations of the IMF to bail out the private sector. Just as an independent central bank is a cornerstone of a credible monetary policy targeting inflation, an independent international bankruptcy court may be the best guarantee against excessive bailouts.<sup>101</sup>

It is interesting to observe in this respect that the plan proposed by the IMF for an SDRM entirely excludes IMF loans and programs from the SDRM. In other words, IMF lending will remain completely unchecked. There may well be strong political considerations behind this decision. While giving a bankruptcy court authority to grant DIP financing may be seen as an important encroachment on a debtor's sovereignty, it may be perceived as an equally unacceptable limitation of the power of the governing board of the IMF. Whatever the reasons behind the proposal to exclude IMF lending may be, this issue underscores the concerns expressed by many commentators about the credibility and authority of an SDRM forum that is not fully independent of the IMF.<sup>102</sup>

Based on the analysis thus far, we can start sketching the outlines of a financing scheme that would adapt the benefits of U.S.-style DIP financing to the sovereign bankruptcy framework. Based on financial considerations alone, the financing provisions should assure priority status to the DIP lender, but the court or other decision maker's discretion to authorize this priority should be restricted rather than unfettered. In many, perhaps most, cases, the IMF should serve as the initial lender. But IMF lending should ideally be subject to the same restrictions as interim financing by other lenders.

The framework we propose is quite simple. The SDRM decision maker should be instructed to distinguish between two categories of proposed priority lending—loan packages that are presumptively permissible and those that are presumptively impermissible. The distinction would be based on the magnitude of the proposed loan, and tied in particular to the sovereign debtor's current trade debt needs. Funds that are needed to finance a sovereign debtor's general trade debt should be approved.<sup>103</sup> Larger loans, on the other hand,

would be presumptively impermissible and would require approval by the court or some other decision maker. The effect would be to authorize enough lending to meet the sovereign's current cash flow needs after a default, while minimizing the risk that the loan's priority status would lead to overborrowing.

By tying presumptively permissible DIP financing to the sovereign's trade debt needs, we do not mean to suggest that larger loans could never be given the special DIP financing priority. Larger loans would be presumptively impermissible, not forbidden per se. There might be good reasons for a larger interim financing arrangement, and sovereigns should, in our view, be able to get DIP financing beyond trade credit, but then the loan should be subject to approval by the bankruptcy court or some other decision maker. Whether the court or a majority of the creditors should have ultimate discretion to approve large DIP financing arrangements involves a delicate balancing of efficiency and political considerations.

In all likelihood, large-scale DIP financing could only be arranged in a truly timely fashion if a court had authority to grant it. To provide a safeguard against excessively profligate judges, creditors could be given the right to challenge a court decision approving extensive DIP financing. The advantage of court approval with a right of creditor challenge is that it would avoid the delays that would attend an alternative such as creditor voting.

Conversely, giving a court the power to approve DIP financing may not be politically feasible. Neither creditors, nor sovereign debtors, nor the IMF may be prepared to give up so much power to a court restructuring sovereign debt. In that case, it is clearly preferable to allow for DIP financing that is approved by a majority vote of all of the sovereign's creditors, rather than to ban it altogether. On balance, we believe that requiring a creditor vote on extensive DIP financing proposals is the most plausible strategy. Although delays such as the time necessary to identify the claims eligible for voting would discourage debtors from proposing such financing, this approach is the most politically feasible, and the chilling effect may in fact be desirable in many contexts.

To summarize: under our proposal, the SDRM would divide interim financing into two categories, based on presumptions as to what is and is not permissible. The decision maker would simply approve loans that were tied to the sovereign's reasonable trade debt needs. Priority financing for larger loans, however, may have to be approved by a majority of the sovereign's creditors. This approach would have the virtue of significantly constraining the SDRM decision maker's discretion, and it would minimize the risk of overborrowing.

### **Who Should the Institutional Decision Makers Be?**

One of the most hotly contested questions in the debate over sovereign bankruptcy is who the decision maker should be. Most existing proposals recommend one of three choices: the IMF, an existing international organization, or a hypothetical new international organization. We begin this section by briefly considering each of the proposed decision-making institutions and by pointing out the serious shortcomings of all of these alternatives. We then propose a very different decision maker: existing corporate bankruptcy courts. As we shall see, existing bankruptcy or insolvency courts offer several intriguing advantages over the competing choices.

### **Shortcomings of the IMF and Other International Institutions**

The most obvious choice as overseer of a new SDRM is the IMF itself. In effect, the IMF already serves as a gatekeeper, since IMF approval is often a prerequisite to restructuring or otherwise addressing a sovereign debt crisis. The IMF's close involvement also gives it much better information about a sovereign's financial predicament than any outside decision maker would have. Given that the IMF is already intimately involved in these issues, and that SDRM oversight could be added to the IMF's job description without altering its mission, one can easily imagine the IMF as the principal bankruptcy decision maker.<sup>104</sup>

For all its benefits, however, IMF oversight has two major drawbacks: first, the IMF would have a significant conflict of interest. As lender of last resort, the IMF is likely to be a creditor of the sovereign debtor. As decision maker, on the other hand, its

responsibility would be to mediate impartially among the various constituencies of the sovereign debtor. The second concern is political. IMF decision making has in some instances been driven more by political pressures by the United States or other G-7 members than by the economics of the crisis in question. As decision maker in a restructuring, its motives and impartiality may continually be questioned, making it ultimately an ineffective administrator of the restructuring process.

Once again, we do not have to look far to find a useful analogy to the dilemma posed by a regulator who acts both as an arbiter among creditors and as one of the creditors. In U.S. banking law, the Federal Deposit Insurance Corporation (FDIC) wears the same two hats. Because the FDIC guarantees the safety of bank deposits, it steps into the shoes of bank depositors if the bank runs into financial distress, which in essence makes the FDIC a bank's largest unsecured creditor. At the same time, the FDIC decides how to dispose of a bank's assets, and determines the treatment of the bank's creditors. During the banking crisis of the 1990s, the FDIC's dual role created or magnified conflicts in a variety of contexts.<sup>105</sup>

The FDIC's special concern with avoiding a costly bank run when a bank encounters financial distress is closely related to the IMF's concern with avoiding currency runs and contagious debt crises. Because of the risk of a bank run, banks cannot be reorganized in the same way as other companies. When insolvent banks are small they are invariably liquidated rather than reorganized, usually through deposit transfers or sales to third parties, and the entire process is arranged by the FDIC in secret before it is announced. The need for speed, secrecy, and regulatory approval all point to the FDIC as the logical overseer.

Secrecy and speed may be just as important in the early stages of a sovereign debt restructuring, and the IMF is well positioned to keep things quiet. But, when it comes to large sovereign debt crises, the IMF may be reluctant to impose aggressive discipline, much as banking regulators are tempted to forbear when a troubled bank is viewed as "too big to fail." Furthermore, the IMF cannot achieve the other benefits that justify FDIC control of bank insolvency proceedings. Unlike bank insolvencies, for instance, sovereign debt

restructurings cannot be resolved by a single decisive transaction such as a liquidation or sale of assets. The process is more complicated and necessarily involves the input of other parties such as the sovereign's major creditors. The IMF will of course play a central role in the restructuring process. But given the IMF's conflicting interests, and its susceptibility to political pressures, it makes more sense to place oversight authority in a more disinterested decision maker.

In addition to the IMF, the other leading option for SDRM oversight is to vest this authority in a new international decision-making body or, in the alternative, to expand the scope of an existing organization. The IMF's most recent approach is a hybrid between IMF oversight and establishing a new SDRM decision maker;<sup>106</sup> thus, we will focus on the possibility of a newly created decision maker in the discussion that follows. As should be evident, however, looking to an existing international organization would raise precisely the same concerns as those we identify above.

Under the IMF's most recent proposal, an independent committee would select the members of a selection committee, and the selection committee would then pick the judges for the decision-making body, the SDDRF.<sup>107</sup> Unlike the IMF, the SDDRF would not have a financial stake in the decisions it makes, and all of its judges would be selected with their independence in mind. The most obvious selling point of the new body is this independence. Unfortunately, even the carefully structured nomination procedure in the IMF's proposal provides no real guarantee of independence. Just reciting the layers of process (e.g., the committee that selects a committee) gives a sense of how susceptible to political pressure the selection process may be. When it comes to actual SDRM decisions, there is a real risk that the SDDRF would not be an impartial decision maker and that the new board's deliberations, like the selection of its members, would be undermined by political considerations.

One could respond to these concerns by adding further guarantees of the tribunal's independence,<sup>108</sup> but the suspicion of political interference is likely to remain. In short, with both the IMF's proposals and those of others to rely on an international decision-making body, there is a serious risk that politics may influence the tribunal's deliberations.

Another potential concern with the proposed SDDRF as currently envisioned is that it may not have sufficient powers to be able to administer the debt restructuring process efficiently. As currently contemplated, the court's strongest sanction is that it may decide to avoid the process entirely and throw the parties back to the current status quo where they must renegotiate the debt without the help of a majority vote binding on a dissenting minority. But wielding such a strong weapon may often not be plausible, and in the absence of any other sanctions it may be difficult for the court to reprimand a sovereign or a creditor that deliberately attempts to slow down the process, submits false claims, or abuses the judicial process in other ways.

### **Tapping the Expertise of Existing Bankruptcy Courts**

As we chronicle the flaws of existing proposals to vest authority over sovereign bankruptcy in the IMF or an international tribunal, we must be careful not to lapse into utopian despair. The fact that a proposal falls short of perfection does not necessarily mean it should be rejected. An imperfect decision maker may be the best option we have in the real world. In this case, however, there may be a better alternative.

We argue in the following paragraphs that authority over the SDRM process should be vested in existing corporate bankruptcy or insolvency courts. Existing courts are not perfect either, but they offer several striking advantages as compared to the IMF or an international organization. In the discussion that follows, we begin by briefly outlining the contours of our proposal. We then will address a series of potential objections to this strategy.

Our proposal is simple: rather than looking to a supranational decision maker, sovereign debtors should be permitted to file for bankruptcy in the courts of any foreign jurisdiction whose law governs a portion of the sovereign's private debt. To avoid the problem of "home court" favoritism, sovereign debtors or creditors should not be allowed to file in the sovereign's own courts, but the sovereign could select the bankruptcy arbiter of any jurisdiction where it issued bonds or bank debt. Under current practice, the majority of sovereign debt is issued in New York and is subject to

New York law. The other major source of bond issues is London, with Tokyo or Frankfurt issuing much smaller shares.<sup>109</sup> This means that most sovereigns could choose from among one or more of these four jurisdictions. A sovereign that followed its New York debt would file in the bankruptcy court for the Southern District of New York; a London case would go to a judge with insolvency jurisdiction over administrative receiverships; and Frankfurt or Tokyo cases would be handled by the bankruptcy courts in those locations.

There is one small qualification. To ensure that sovereign debtors did not issue debt in a jurisdiction on the eve of default solely for the purpose of gaining access to the jurisdiction's bankruptcy courts, a sovereign's venue choice should be limited to jurisdictions where it had issued debt at least 18 months before bankruptcy.<sup>110</sup> Other than this timing limitation, however, together with a minimum amount requirement, sovereigns could file wherever they issued their debt.

Perhaps the most important benefit of this approach, as compared to employing the IMF or an international body, is that it relies on an existing decision maker and legal community that already have the relevant expertise and authority to conduct the judicial process. In each of these courts, moreover, initial decisions are made by a single judge. As a result, courts would be well positioned to make immediate decisions on issues like interim financing; there would be no need to wait until, say, an arbitral panel was assembled to oversee the case. In addition, the bankruptcy or insolvency judge would be much less likely than the IMF or the SDDRF to be subject to political pressures. In short, the conflict-of-interest concerns that would bedevil each of the other proposed decision makers do not loom nearly as large for bankruptcy courts.

The first and most obvious objection to our proposal is that giving sovereign debtors a choice of filing locations will enable them to shop for the laxest forum and perhaps lead to a race to the bottom, with courts exacerbating debtors' moral hazard by making it too easy for sovereigns to shed their debt.<sup>111</sup> This is the same kind of complaint that has been lodged against the U.S. corporate bankruptcy framework. In the United States, most corporate debtors have a variety of filing options, and several courts—most prominently Delaware and New York—have attracted a disproportionate number

of the biggest cases.<sup>112</sup> Critics complain that the judges in these jurisdictions have undermined the bankruptcy process by rushing cases along, being too generous in paying attorneys' and bankruptcy fees, or by favoring debtors and their managers—the allegations vary—in order to attract these reputation-enhancing cases.<sup>113</sup>

Rather than undermining the case for giving sovereign debtors a choice of bankruptcy court, the forum-shopping analysis actually proves on inspection to underscore its attractions. To see this, note first that even with corporate debtors, the venue-shopping complaints are largely misguided. Although critics complain that Delaware is too friendly to managers or their attorneys, for instance, this does not explain the fact that creditors often are the ones who insist that the case be filed in Delaware.<sup>114</sup> Bankruptcy lawyers who have handled cases in Delaware usually attribute Delaware's popularity to the speed of Delaware cases and the expertise of its bankruptcy judges. This is consistent with the existing empirical data, which suggests that Delaware cases were much faster than cases in other jurisdictions in the 1990s, and that debtors were most likely to file in Delaware rather than their "home court" (that is, the jurisdiction where the company's headquarters or principal assets were located) if the home court was inexperienced or the case was especially complex.<sup>115</sup>

Sovereigns can be expected to take similar considerations into account when they select a filing location. A sovereign that wishes to restructure its obligations quickly and return to the capital markets will pay especial attention to the expertise of the respective bankruptcy courts, and the courts, in turn, have an incentive to demonstrate efficiency and expertise if they wish to attract important cases. It is also worth noting that tying the choice of courts to the location of the sovereign's debt—New York, London, Frankfurt, or Tokyo for most sovereign debtors—assures that the case will be overseen by a jurisdiction that is likely to be sympathetic to the sovereign's creditors. Requiring the case to be filed in a creditor jurisdiction provides a useful counterbalance to the sovereign debtor's advantages—in particular, its rights to invoke the SDRM and to select the filing location. In short, jurisdiction shopping is a significant virtue of, not a problem for, the proposal.



A second possible concern is that ordinary courts cannot handle cases that have such large international implications as would a sovereign bankruptcy proceeding. Only an arbiter with international credentials, in this view, could oversee an SDRM.<sup>116</sup> Before the late 1970s, when sovereigns first started routinely waiving their traditional immunity from litigation,<sup>117</sup> this objection would have carried more weight. But we now have a much more extensive track record of domestic courts resolving issues involving sovereigns. Certainly, sovereign bankruptcy is a more elaborate proceeding than most legal issues, but the court's oversight role is also quite constrained under the framework we have proposed, which leaves much of the process to be worked out by the parties. Nor should the magnitude of the cases be cause for alarm. New York and London courts already have experience handling huge bankruptcies. The bankruptcies of companies such as Maxwell, Polly Peck, WorldCom, and Global Crossing, for instance, involve larger amounts of outstanding debt than most sovereign debt restructuring cases. Particularly if the cases are brought in major economic centers like New York, London, or Tokyo, a commercial bankruptcy or insolvency judge will be equal to the oversight task.

A final, somewhat similar objection focuses on a court's difficulty in implementing sovereign bankruptcy rules that differ markedly from the jurisdiction's domestic bankruptcy or insolvency rules. Once again, there is much less to this objection than meets the eye. Given the similarities between the SDRM and U.S. Chapter 11, this objection would worry about judges in London or Tokyo, whose bankruptcy systems are much less oriented toward reorganization. But there is no reason to believe that London or Tokyo judges would find the SDRM disorienting, either. The framework is quite simple, and courts have managed to apply unfamiliar rules in other contexts.<sup>118</sup> Moreover, London bankers and lawyers have been strong advocates of sovereign bankruptcy, and the SDRM is in many respects simply an elaboration of the collective action provisions that are already included in the sovereign debt governed by London law. It is hard to imagine that London judges will find sovereign bankruptcy, with its strong London influence, uncongenial.

To summarize, vesting SDRM authority in domestic bankruptcy judges avoids the politicization that would undermine international decision makers. Decisions would be made promptly, and the threat of political meddling or conflicts of interest would be much lower. Giving the sovereign debtor a choice to file in any jurisdiction where it has issued debt would reinforce these virtues by creating healthy interjurisdictional competition among bankruptcy courts. A court that wished to attract sovereign bankruptcy cases would need to establish a reputation for efficiency and expertise, and the competition to do so would enhance the quality of all of the courts where a sovereign debtor might file.

Indeed, the attractions of jurisdictional competition raise the question of whether we might want to go even further, and instruct sovereigns to specify their SDRM location *ex ante*. Under this *ex ante* (or pure jurisdictional choice) approach, each sovereign would pick a single jurisdiction as its filing location in the event it later invoked the SDRM. This *ex ante* choice strategy, which has been advocated in the international insolvency and corporate bankruptcy contexts,<sup>119</sup> has significant theoretical attractions. Since sovereigns would pick a jurisdiction before they borrowed additional new funds—and their choice would be limited to a single court—their cost of credit would fully reflect the merits or demerits of the court they selected. Sovereigns that selected an inefficient (e.g., excessively pro-debtor) decision maker would (in theory) face higher credit costs. This would give the sovereign a strong incentive to seek, and courts an incentive to provide, efficient SDRM oversight.

While we recognize the virtues of a pure jurisdictional choice strategy, linking the SDRM decision maker to the sovereign's issuance of debt is preferable for several reasons. Perhaps the most important problem with precommitting to a particular jurisdiction is the difficulty of making midstream corrections. Once a debtor has made its choice, it is very difficult to change its selection later if subsequent events make the original choice ill-advised.<sup>120</sup> The debtor is in a much better position to select a filing location at the time of filing than it is when there is no filing in prospect. Second, there may be sovereignty concerns about a sovereign's precommitting to a particular nation's bankruptcy or insolvency courts in the event of a

future sovereign bankruptcy filing. Third, the prospect that a sovereign could choose any jurisdiction in the world as the filing location, even one with no ties to the debtor or any of its creditors, could provoke political resistance to the SDRM. As a practical matter, we suspect that most sovereigns would select New York, London, Tokyo, Zurich, or Frankfurt as their filing location, even if they had unbridled discretion *ex ante*, since sovereigns who chose a potential lax jurisdiction would pay the price for this choice in the credit markets. But, given the practical and political concerns we have just noted, the best way to structure the jurisdictional choice is to give sovereigns the *ex post* option to file for bankruptcy in any location where they have issued sovereign debt.

### **Should Designer SDRMs Be Permitted?**

Throughout our analysis, we have assumed that the sovereign bankruptcy framework will use a one-size-fits-all approach. Policymakers will develop a single set of provisions dealing with the issues we have discussed—the standstill, classification, voting, and so on—and the framework will then be implemented through a treaty process. As a conceptual matter, adopting a uniform, mandatory set of SDRM provisions obviously is the simplest approach. But it is not the only way to proceed. An alternative strategy might permit sovereigns to design a sovereign bankruptcy framework that fits their own particular circumstances.

This section argues that sovereigns should be given precisely this kind of flexibility. We begin by pointing out that there is both theoretical support and, more intriguingly, historical precedent for permitting designer SDRMs. We then briefly explore how sovereigns might tailor the bankruptcy framework, and conclude by considering whether sovereigns should be prevented from adopting provisions that make restructuring more, rather than less, difficult.

Some of the most innovative work in the legal literature on corporate bankruptcy in recent years has focused on the possibility of designing bankruptcy provisions by contract. According to proponents of bankruptcy contract, if courts did not prohibit companies from waiving their right to file for Chapter 11 in the

United States, a company and its creditors could improve on the existing statutory framework by devising their own bankruptcy rules to address central issues such as managers' choice whether to reorganize or liquidate the firm.<sup>121</sup> Critics, however, have questioned whether tailored bankruptcy provisions would be cost-justified for a healthy company and whether they could be effectively adjusted to take account of the debtor's borrowing arrangements with subsequent creditors.<sup>122</sup> Even if one views the most optimistic claims for a bankruptcy contract with skepticism, this literature underscores the virtues of giving a debtor and its creditors the right to opt out of the existing statutory framework if they wish.

Interestingly, the possibility of a tailored approach to bankruptcy—or at the least, to some of its key terms—is not simply hypothetical.<sup>123</sup> In order to pass the first truly permanent U.S. bankruptcy law at the end of the nineteenth century, bankruptcy proponents were forced to make a series of compromises with Southern and Western lawmakers who opposed the legislation.<sup>124</sup> Particularly important was a provision permitting each state to determine what property debtors in that state could exempt from their creditors if the debtor filed for bankruptcy. The beauty of this compromise was that it enabled state lawmakers to adjust their exemptions in accordance with local norms as to what (and how much) property a debtor should retain in order to facilitate a “fresh start” after bankruptcy. Bankruptcy law was federal, but it was (and still is) tailored in significant respects on a state-by-state basis.

This historical precedent has direct implications for sovereign bankruptcy. Although proponents of an SDRM have not recommended that sovereigns be permitted to tailor the provisions in any way, we suspect this may simply be because they have not yet focused on the issue. Once we shine the spotlight on the question, the case for at least limited opt-out is compelling. To see this, suppose that a nation had the same kinds of concerns for its citizens' welfare that Southern and Western states had in the United States in the nineteenth century. One manifestation of this might be social welfare protections that the sovereign debtor wished to guarantee to its citizens even in the event of financial distress. Permitting the sovereign debtor to include this protection in its version of the SDRM

would provide the same benefits as did the exemptions compromise in U.S. bankruptcy law: not only would opt-out permit sovereign debtors to tailor the SDRM to local norms, but it could also have the political benefit of increasing their willingness to adopt a sovereign bankruptcy framework.

To be sure, if every sovereign adopted a different SDRM, this might complicate creditors' efforts to price sovereign debt. But the pricing of sovereign debt is already complex and nation-specific; it is unlikely that a tailored SDRM would add significantly to this complexity. Moreover, we suspect that the kind of provision we have described would be the exception rather than the rule. Most sovereigns would hesitate to add provisions that, as with a social welfare opt-out, softened the effect of financial distress and thus interfered with the priority of the sovereign's creditors. Sovereigns that included such provisions would face higher credit costs *ex ante*. Only if there was an extremely strong local commitment to the protection in question would a sovereign soften the framework rather than sticking with the status quo.

But what about opting out of the SDRM to add harsher provisions, rather than softer ones? Here, things get a bit trickier. Given their desire to maximize access to credit and minimize its costs, sovereign borrowers have a greater incentive to adopt harsh bankruptcy provisions rather than soft ones. Recall from our discussion at the outset of the chapter that sovereigns may in fact agree to make restructuring too difficult, since, among other things, current political leaders enjoy the benefits of a lower cost of credit but are not likely to be around to bear the consequences of any problems this causes down the road.<sup>125</sup> Under these circumstances, contractual flexibility may not always lead to an efficient result. The question, then, is this: should sovereigns be precluded from adopting amendments to make restructuring more rather than less difficult?

Despite the risk that an opt-out may include inefficiently harsh terms, we believe, on balance, that sovereigns should be given at least some limited flexibility to opt (or not opt) out of aspects of the SDRM as they see fit. For example, some sovereigns may have acquired a solid reputation of creditworthiness at the cost of strict and

prolonged fiscal discipline. These sovereigns may fear that their reputational capital will be watered down by the introduction of the SDRM and may therefore be opposed to its adoption. If these sovereigns are prepared to support the SDRM only if they can opt out of some provisions—for example, if they can strengthen the supermajority rule required to approve a restructuring plan—this may be a small political price to pay to be able to implement an SDRM procedure.

Once again, as with our case for opt-out in general, our defense of full flexibility rests in part on theoretical considerations and in part on political ones. The theoretical case for flexibility is quite simple. Although there is a real risk of inefficiently harsh terms, some sovereigns may have legitimate reasons to tinker with the framework in ways that make restructuring more difficult. We are hesitant to cut off an alternative that might make sense for some sovereign debtors. But the political factors point in the opposite direction and, in our view, outweigh the virtues of flexibility. We suspect that both sovereign debtors and their creditors would be hostile to a sovereign bankruptcy proposal that could be softened but not tightened. Creditors would complain that this approach encourages moral hazard and easy default, and sovereigns would worry about the effect on their access to credit. If sovereigns are permitted to tailor the SDRM to fit their needs—and we think they should be—they should therefore be given the flexibility to adopt provisions that make the framework harsher rather than softer if they so choose.

This is not to say that complete flexibility to opt out should be allowed. Clearly, an opt-out of the entire scheme would not achieve any gain relative to the current status quo. Thus, all members should be subject to the broad main provisions of the SDRM, but they should also be allowed to strengthen or weaken somewhat specific provisions like the majority rule, stay, DIP financing, and classification provisions to reflect their specific circumstances in light of how they affect the balance between the interests of creditors and those of the sovereign.<sup>126</sup>

## Conclusion

We have argued that neither the existing approach to sovereign debt crises—ad hoc efforts to restructure, together with the prospect of an IMF-led bailout—nor increased use of collective action provisions is an adequate response. Because of their short-term focus, sovereign decision makers may agree to excessively harsh conditions on restructuring, and the prospect of bailouts creates serious moral hazard on the part of creditors. Collective action provisions might facilitate restructuring in some cases, but they will only be effective if the sovereign debtor has a relatively simple capital structure; and this strategy may not scale down the sovereign's debt enough to fully resolve its financial crisis.

The IMF's proposed SDRM is an important step forward. Not least of the benefits of a sovereign bankruptcy framework is that it would enable the IMF to credibly commit not to bail out troubled sovereigns. Rather than bailouts, sovereigns would need to look to the SDRM. Unfortunately, the IMF framework is flawed in important respects. Although it would help to solve the coordination problems faced by sovereign debtors and their creditors, it does not adequately address the issue of creditors' priority. Under current conditions, it is very difficult for the parties to create enforceable priorities, a dilemma that creates a great deal of uncertainty in sovereign credit markets. We have argued that a sovereign bankruptcy framework can and should be used to remedy this problem. By adopting a strict first-in-time priority scheme, and adhering to absolute priority in the classification and voting process, the SDRM could enhance sovereign credit markets *ex ante*, as well as providing a mechanism for resolving sovereign debt crises *ex post*.

Our proposal also includes a variety of other significant features, including a special but limited priority for interim financing that analogizes to the approach used in railroad receiverships in the United States in the late nineteenth and early twentieth centuries. Unlike other commentators, who propose that a new or existing international body oversee the sovereign bankruptcy process, we argue that decision-making authority should be vested in the existing bankruptcy or insolvency courts of any jurisdiction where the sovereign has

issued debt. We also argue that sovereigns should be permitted to tailor the bankruptcy framework in many respects.

No proposal is perfect, of course, and ours could no doubt be improved in various ways. But a proposal along these lines would address many of the problems that have bedeviled the existing responses to sovereign debt crises.



## Notes

The text of this chapter was first published as an article in the *Emory Law Journal*: Patrick Bolton and David A. Skeel, Jr., “Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?” 53 *Emory L.J.* 763 (2004).

<sup>1</sup> One of the early articles in this line is Christopher Oechsli, “Procedural Guidelines for Renegotiating LDC Debts: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act,” 21 *Virginia Journal of International Law* 305 (1981). See also Kenneth Rogoff and Jeromin Zettelmeyer, “Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001,” 49 *IMF Staff Papers* 3 (2002), at 470 (surveying the history); Steven L. Schwarcz, “Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach,” 85 *Cornell Law Review* 956 (2000).

<sup>2</sup> For a useful chronology of the IMF’s increasing involvement, see Hal S. Scott, “A Bankruptcy Procedure for Sovereign Debtors?” 37 *International Lawyer* 103 (2003). Scott points out that IMF debt has increased nearly a hundredfold since 1970, rising from US\$800 million in 1970 to US\$78.9 billion in 1999, *id.* at 105.

<sup>3</sup> See IMF, “The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations” (2002) [hereinafter “SDRM Design”], <http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf>. The IMF adjusted this proposal several months later. IMF, “Proposed Features of a Sovereign Debt Restructuring Mechanism” (2003) [hereinafter, “SDRM Features”], <http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf>. The new proposal followed several earlier, less detailed IMF proposals that were delivered by Anne Krueger, the IMF’s First Deputy Managing Director. See, e.g., Anne O. Krueger, “New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking,” Address before the Institute for International Economics (April 1, 2002), <http://www.imf.org/external/np/speeches/2002/040102.htm>.

<sup>4</sup> Michael M. Phillips, “Bush Clears Way for Treaty That Eases Bankruptcies for Developing Nations,” *Wall Street Journal Europe* (September 17, 2002), at A2 (quoting Charles Dallara and describing the IIF as “the research arm of 325 financial institutions and investors”).

<sup>5</sup> For a fascinating and ambitious account of the benefits of collective action provisions, see Lee C. Buchheit and G. Mitu Gulati, “Sovereign Bonds and the Collective Will,” 51 *Emory Law Journal* 1317 (2002).

<sup>6</sup> In 2003, Mexico registered an issuance of New York bonds that included a voting provision, apparently after strong encouragement by the U.S. Treasury to include the provision. *See, e.g.*, John Authers, “Mexico Sends Strong Signal with Bond Clauses,” *Financial Times* (February 27, 2003), at 31. Since then, other sovereign issues have followed suit. For discussion, see, for example, Nouriel Roubini and Brad Setser, “The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode,” 1 *Journal of Restructuring Finance* 1, at 6 (2004).

<sup>7</sup> Perhaps in part due to this concern, the U.S. Treasury, a prominent supporter of CACs, has not entirely ruled out a more ambitious approach toward debt restructuring.

<sup>8</sup> The first article to attempt a more extensive analysis was Schwarcz, *supra* note 1.

<sup>9</sup> Absolute priority is the general requirement that higher priority creditors be paid in full before lower priority creditors receive anything. For a recent assessment of the costs and benefits of deviating from absolute priority, see Lucian Arye Bebchuk, “Ex Ante Costs of Violating Absolute Priority in Bankruptcy,” 57 *Journal of Finance* 445 (2002).

<sup>10</sup> Ecuador apparently negotiated with the collateralized bonds first because the bonds gave the country a 30-day grace period, during which Ecuador would not technically be in default. *See* Barry J. Eichengreen and Christof Ruehl, “The Bail-In Problem: Systemic Goals, Ad Hoc Means,” National Bureau of Economic Research, Working Paper No. W7653, April 2000, <http://ssrn.com/abstract=228127>, at 16–17.

<sup>11</sup> *Id.* at 18.

<sup>12</sup> Because our emphasis in this discussion is on the contours of the sovereign bankruptcy framework itself, we do not discuss the question of implementation. A brief note is therefore in order here. Several of our proposals—such as the proposed standstill and the use of majority voting for the restructuring of a sovereign’s debt—would require an amendment to the IMF’s Articles of Agreement. Amendment of the Articles of Agreement requires the approval of 85 percent of member-country votes. For a much more detailed discussion, see IMF, SDRM Design, *supra* note 3, at 70–73. Our proposal could be implemented through the same process contemplated by the IMF.

<sup>13</sup> The leading proponent of this view has been Michael Dooley. *See* Michael P. Dooley, “Can Output Losses Following International Financial Crises Be

Avoided?” National Bureau of Economic Research, Working Paper No. W7531, February 2000, <http://ssrn.com/abstract=216008>.

<sup>14</sup> The analysis that follows draws on Patrick Bolton, “Towards a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World,” 50 *IMF Staff Papers* (September 2003), at 41, 61–62. See also Robert K. Rasmussen, “Integrating a Theory of the State into Sovereign Debt Restructuring,” 53 *Emory Law Journal* 1163 (2004) (making a similar point).

<sup>15</sup> For a more detailed analysis of this problem, see Patrick Bolton and Olivier Jeanne, “Structuring and Restructuring Sovereign Debt: The Role of Seniority” (April 2004) (unpublished manuscript, on file with authors).

<sup>16</sup> See, e.g., Eichengreen and Ruehl, *supra* note 10, at 2, n.3; *supra* notes 5–6 and accompanying text.

<sup>17</sup> For a fascinating discussion of collective action provisions, and proposals for improving them, see Buchheit and Gulati, *supra* note 5. See also William W. Bratton and G. Mitu Gulati, “Sovereign Debt Restructuring and the Best Interest of Creditors,” 57 *Vanderbilt Law Review* 1 (2004) (analyzing collective action provisions and choice between majority voting and unanimity requirement).

<sup>18</sup> E.g., e-mail from Lee C. Buchheit, Partner, Cleary, Gottlieb, Steen and Hamilton, to David A. Skeel, Jr., Professor of Law, University of Pennsylvania Law School (December 11, 2002) (on file with authors).

<sup>19</sup> One of the objections frequently lodged against the campaign for majority voting is that it would not affect the many bonds that have already been issued and do not have CACs. See, e.g., Eichengreen and Ruehl, *supra* note 10, at 12 (noting this objection). We put this objection to one side, both because it is a transition problem rather than a permanent limitation, and because CACs could be added to existing bonds through exchange offers if sovereign debtors and their creditors were persuaded of their desirability.

<sup>20</sup> The complexity of the railroads capital structure, rather than simply negotiability concerns, almost certainly was one of the reasons that U.S. issuers were much less likely than their U.K. counterparts to include CACs in their corporate bonds. See David A. Skeel, Jr., “Can Majority Voting Provisions Do It All?” 52 *Emory Law Journal* 417 (2002) (drawing on the equity receivership analogy and responding to Buchheit and Gulati, *supra* note 5). For a more skeptical view of the equity receivership analogy, see Stephen J. Lubben, “Out of the Past: Railroads and Sovereign Debt Restructuring,” 35(4) *Georgetown Journal of International Law* (2004).

<sup>21</sup> For a discussion of the formation and activities of sovereign bondholder committees in the early twentieth century, one which points out some of their limitations, see Barry Eichengreen and Richard Portes, “Crisis? What Crisis? Orderly Workouts for Sovereign Debtors,” in Barry Eichengreen and Richard Portes, eds., *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* 3, at 28–30 (London: CEPR, 1995).

<sup>22</sup> The discussion that follows is drawn from Bolton, *supra* note 14, at 64. We should emphasize that the point here is relative; even a comprehensive restructuring mechanism can leave debtors with too much debt. See, e.g., Stuart C. Gilson, “Transactions Costs and Capital Structure: Evidence from Financially Distressed Firms,” 52 *Journal of Finance* 161 (1997) (empirical study showing the firms reduce debt more in Chapter 11 than in nonbankruptcy workouts, but that Chapter 11 firms retain a high debt load); Mark J. Roe, “Bankruptcy and Debt: A New Model for Corporate Reorganization,” 83 *Columbia Law Review* 527 (1983) (considering factors that may induce the parties to agree to Chapter 11 reorganization plans that do not eliminate enough debt). Bankruptcy, however, is likely to produce a more thorough restructuring than CACs and other nonbankruptcy approaches.

<sup>23</sup> See, e.g., Elhanan Helpman, “Voluntary Debt Reduction: Incentives and Welfare,” in Jacob A. Frenkel et al., eds., *Analytical Issues In Debt*, at 279 (Washington: IMF, 1989); Kenneth Ayotte, “Bankruptcy and Entrepreneurship: The Value of a Fresh Start” (October 6, 2003), <http://ssrn.com/abstract=463000>.

<sup>24</sup> See *supra* notes 10–11 and accompanying text.

<sup>25</sup> See, e.g., Eichengreen and Ruehl, *supra* note 10, at 18.

<sup>26</sup> See Jeremy Bulow and Kenneth Rogoff, “Cleaning Up Third World Debt Without Getting Taken to the Cleaners,” *Journal of Economic Perspectives* (Winter 1990), at 31.

<sup>27</sup> Buchheit and Gulati, *supra* note 5, at 1348–51.

<sup>28</sup> IMF, SDRM Design, *supra* note 3.

<sup>29</sup> For an extensive analysis of the relevance of corporate bankruptcy principles to an SDRM, see Bolton, *supra* note 14. See also Skeel, *supra* note 20 (response to Buchheit and Gulati, *supra* note 5, analogizing to equity receiverships in U.S. bankruptcy history).

<sup>30</sup> IMF, SDRM Design, *supra* note 3, at 7 (suggesting that the SDRM provisions should “resolve[...] a critical collective action problem” but do so “in a manner that minimizes interference with contractual rights and obligations”).

<sup>31</sup> *Id.* at 10 (calling for voting threshold of 75 percent of registered and verified claims).

<sup>32</sup> *Id.* at 9–10 (concluding that there should be “no generalized stay on enforcement”). The November 27, 2002, proposal did leave open the possibility of a creditor vote to impose a stay on a specified action, *id.* at 35, and the IMF subsequently suggested that a stay might be imposed if requested by the sovereign debtor and approved by both a creditors’ committee and the SDRM decision maker, IMF, SDRM Features, *supra* note 3, at 11–12.

<sup>33</sup> IMF, SDRM Design, *supra* note 3, at 35–37 (explaining and adopting the hotchpot rule used for corporate debtors in some jurisdictions).

<sup>34</sup> *Id.* at 37; IMF, SDRM Features, *supra* note 3, at 10–11.

<sup>35</sup> *See, e.g.*, IMF, SDRM Design, *supra* note 3, at 8–9 (summarizing provisions for determining “eligible claims”).

<sup>36</sup> The problem of sovereign control of key claims, and through these claims, of a vote by creditors, figured prominently in a sovereign debt dispute involving Brazil in the 1990s. Through Banco di Brasil, which had participated in a syndicated loan agreement, Brazil managed to thwart an effort by other holders of the debt to accelerate the amounts due under the loan. *CIBC Bank and Trust Co. v. Banco Central do Brasil*, 886 F. Supp. I 105 (S.D.N.Y. 1995) (refusing to intervene to impose implied obligations of good faith and fair dealing). For discussion and criticism, see Bratton and Gulati, *supra* note 17.

<sup>37</sup> *See* IMF, SDRM Design, *supra* note 3, at 13 (“[A] debtor may decide to exclude certain types of claims from a restructuring, particularly where such exclusion is needed to limit the extent of economic and financial dislocation.”).

<sup>38</sup> *Id.* at 24–25.

<sup>39</sup> *Id.* at 53.

<sup>40</sup> *Id.* at 40.

<sup>41</sup> In the corporate context in the United States, debtors invariably arrange their DIP financing before they even file for bankruptcy. *See, e.g.*, David A. Skeel, Jr., “The Past, Present and Future of Debtor-in-Possession Financing,” 25 *Cardozo Law Review* 1905 (2004).

<sup>42</sup> The parameters of the SDDRF, as described in the text that follows, are outlined in IMF, SDRM Design, *supra* note 3, at 56–70.

<sup>43</sup> *See, e.g., supra* note 9.

<sup>44</sup> The classic theoretical account of bankruptcy as a solution to collective action problems is Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Beard Books, 2001).

<sup>45</sup> 11 U.S.C. § 362(a) (2000).

<sup>46</sup> For an overview of the English insolvency rules, see, for example, John Armour et al., “Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom,” 55 *Vanderbilt Law Review* 1699, at 1736–50 (2002). Secured creditors’ rights have been tempered somewhat by the enactment of the Enterprise Act 2002. *See, e.g.*, John Armour and Rizwaan Jameel Mokal, “Reforming the Governance of Corporate Rescue: The Enterprise Act 2002” (May 2004) (unpublished manuscript, on file with authors).

<sup>47</sup> For a survey of the presence or absence of a stay in nations throughout the world as part of an assessment of creditors’ rights generally, see Rafael La Porta et al., “Law and Finance,” 106 *Journal of Political Economy* 1113, at 1135 (1998).

<sup>48</sup> Schwarcz, *supra* note 1, at 984.

<sup>49</sup> *Id.* at 985.

<sup>50</sup> IMF, SDRM Design, *supra* note 3, at 33–39 (arguing that the hotchpot rule obviates the need for a stay, but leaving open the issue whether creditors could vote to enjoin an enforcement action that threatened to undermine the restructuring process).

<sup>51</sup> Jeff Sachs notes, for instance, that during the Russian financial crisis of the early 1990s, “individual creditors [were] free to harass Russia with legal challenges or other forms of pressure,” and that Russia responded by “ma[king] side payments to particular banks, in order to avoid harassment or to curry special favors;” Jeffrey D. Sachs, “Do We Need an International Lender of Last Resort?” Frank D. Graham Lecture, Princeton University, at

13, n.8 (April 1995), <http://www.earthinstitute.columbia.edu/about/director/pubslint/llr.pdf>.

<sup>52</sup> The most notorious example was the strategic use of the *pari passu* clause included in most bonds by one Elliott Associates, a vulture investor. When Peru restructured its bonds by exchanging them for new, scaled-down bonds, Elliott declined to tender into the restructuring. It then persuaded a Belgian court to attach funds that were intended for bondholders who had agreed to the restructuring. For an analysis of the Elliott strategy, see, for example, G. Mitu Gulati and Kenneth N. Klee, “Sovereign Piracy,” 56 *Business Lawyer* 635 (2001).

<sup>53</sup> The IMF initially called for something like this approach. In her April 2002 speech, Anne Krueger suggested that the stay be conditioned on creditor approval, although she also noted that it might make sense to impose a limited, automatic stay at the outset of the case. Krueger, *supra* note 3, at 10.

<sup>54</sup> The most recent IMF proposal recommends that the creditor-vote approach be considered, but stops short of formally proposing this strategy. See, e.g., IMF, SDRM Design, *supra* note 3, at 9–10. In order to minimize the need for a stay, the IMF proposes that the SDRM include a version of the European hotchpot rule, under which the payout to a creditor that manages to recover some of what it is owed before the restructuring is completed is reduced to the extent of this earlier payout. *Id.* at 35–38. The goal of the hotchpot rule is to discourage creditors from trying to collect early. The rule is only likely to prove effective with creditors who might otherwise be able to obtain a limited payment outside of the restructuring. A creditor that could obtain most or all of what it was owed, that is, more than the creditor expects to receive in the restructuring, still has an incentive to jump the gun.

<sup>55</sup> See generally David A. Skeel, Jr., “Creditors’ Ball: The ‘New’ New Corporate Governance in Chapter 11,” 152 *University of Pennsylvania Law Review* 917, at 940–41 (2003).

<sup>56</sup> It is worth noting that in bankruptcy systems that either limit or omit the stay there is generally one or a small group of creditors (usually banks) who have a property interest in the debtor’s principal assets. This creditor (or creditors) effectively controls the process, which obviates the need for a stay. Moreover, systems that lack a stay are generally biased toward liquidation. The sovereign debt context does not fit either of these patterns.

<sup>57</sup> Sovereigns are different from ordinary corporate debtors in this regard. Whereas the managers of a corporate debtor are likely to be directly

involved in any significant litigation involving the firm, litigation against a sovereign will often be handled by different officials than the ones who participate in the SDRM.

<sup>58</sup> Our proposal thus draws a sharp distinction between judgments obtained up to the point of bankruptcy, and those obtained during the restructuring process. U.S. corporate bankruptcy law takes this principle a step further, and permits the trustee to invalidate liens or other property interests obtained up to 90 days before bankruptcy pursuant to the Bankruptcy Code's preference provision. 11 U.S.C. § 547(b) (2000) (90-day reachback for ordinary creditors, extended to one year for insiders). In the interest of keeping our proposal as simple as possible, we have not advocated that U.S.-style preference provisions be implemented in the sovereign bankruptcy context. But our proposal could easily be adjusted to include a preference provision if subsequent experience suggests the need for this kind of reachback.

<sup>59</sup> For a discussion of currency runs, and an argument that capital controls are an essential response, see, for example, Sachs, *supra* note 51, at 10 (arguing that “a temporary peg of the exchange rate, backed by adequate foreign exchange reserves, can overcome the problem of self-fulfilling currency flight,” but that long-term use of fixed exchange rates is futile).

<sup>60</sup> See, e.g., Schwarcz, *supra* note 1, at 982.

<sup>61</sup> *Id.*

<sup>62</sup> We do not want to overstate this argument. It is certainly possible that a sovereign would collude with some of its creditors in connection with an involuntary bankruptcy filing. But we think this is relatively unlikely, given the consequences of a filing.

<sup>63</sup> Although U.S. bankruptcy law has a much more lenient requirement for involuntary petitions, see 11 U.S.C. § 303(b) (requiring three creditors with a total of \$11,625 in unsecured claims); the kind of percentage requirement we propose is similar to the rules for creditor initiation under other nations' corporate bankruptcy laws. See, e.g., La Porta et al., *supra* note 47, at 1135 (listing petition requirements).

<sup>64</sup> See, e.g., Jeremy Bulow, “First World Governments and Third World Debt: A Bankruptcy Court for Sovereign Lending?” 2002(1) *Brookings Papers on Economic Activity*, at 229.

<sup>65</sup> Moreover, to the extent there are benefits to permitting at least modest deviations from absolute priority, these benefits are already embedded in the



sovereign debt context. Corporate bankruptcy scholars have pointed out that Chapter 11's deviations from absolute priority, and the fact that managers continue to run the business in bankruptcy, may dampen the incentive to take excessive risks on the eve of bankruptcy. *See, e.g.*, Thomas H. Jackson and Robert E. Scott, "On the Nature of the Creditors' Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain," 75 *Virginia Law Review* 155, at 169–74 (1989). Because sovereigns cannot be liquidated, and sovereign bankruptcy will not displace the leadership of a country, the benefits (and risks) of a "soft landing" are built into the SDRM process. As a result, it makes sense for the sovereign bankruptcy framework itself to focus on the goal of limiting any further deviations from absolute priority.

<sup>66</sup> The term "soft budget constraint" has been coined by János Kornai, "'Hard' and 'Soft' Budget Constraint," 25 *Acta Oeconomica* 231 (1980).

<sup>67</sup> A "hard budget constraint" is the constraint a borrower faces when there are no bailouts or other forms of subsidized lending. *See id.*

<sup>68</sup> *See* G-10, "The Resolution of Sovereign Liquidity Crises" (1996), <http://www.bis.org/publ/gten03.pdf>; Peter B. Kenen, *The International Financial Architecture: What's New? What's Missing?* (Washington: IIE, 2001).

<sup>69</sup> For discussion of this response, and the inefficiencies it creates, see Bolton and Jeanne, *supra* note 15.

<sup>70</sup> For a recent review of the benefits of absolute priority and the effects of deviation from it in the corporate context, see Bebchuk, *supra* note 9.

<sup>71</sup> Perfected property interests, including security interests in personal property and mortgages on real estate, are given priority in bankruptcy as to the collateral pursuant to 11 U.S.C. § 725 (2000).

<sup>72</sup> *Id.* § 362(a).

<sup>73</sup> *See, e.g., id.* § 362(d)(1) (creditor entitled to relief if it lacks "adequate protection").

<sup>74</sup> *Id.* § 1122 (requiring classification of claims and interests).

<sup>75</sup> The veto power of each class stems from the fact that a consensual reorganization plan cannot be confirmed unless the proper majorities of every class approve the plan. *See id.* § 1129(a)(8) (requiring approval by all classes).

<sup>76</sup> Under § 1129(a)(7), the “best interest of the creditors” rule, a plan can only be confirmed if every dissenting creditor or equity holder will receive at least as much as they would receive in a liquidation. The “cram-down” rule comes into play if all of the requirements for a consensual reorganization under § 1129(a) are met except § 1129(a)(8), the requirement that every class approve the plan. If one or more classes dissent, the plan can be confirmed nonconsensually—as a “cram down”—under § 1129(b) if, among other things, it satisfies the absolute priority rule with respect to every dissenting class. *See id.* § 1129(a)–(b). These rules are discussed in more detail *infra*. *See also* David A. Skeel, Jr., “The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases,” 78 *Virginia Law Review* 461 (1992) (explaining and analyzing the Chapter 11 voting process).

<sup>77</sup> *See* 11 U.S.C. § 1121 (giving the debtor-in-possession a 120-day “exclusivity period”).

<sup>78</sup> *Id.* § 1129(b).

<sup>79</sup> *Id.* § 1129(a)(7). Unanimity would be required because any creditor in the class can raise an objection alleging that it is not receiving as much as in a liquidation.

<sup>80</sup> *See, e.g.*, Lynn M. LoPucki and William C. Whitford, “Bargaining Over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies,” 139 *University of Pennsylvania Law Review* 125 (1990) (noting courts’ and bankruptcy lawyers’ reluctance to use cram down).

<sup>81</sup> *See, e.g.*, Douglas G. Baird and Robert K. Rasmussen, “Chapter 11 at Twilight,” 56 *Stanford Law Review* 673, at 692 (2003) (noting that “equity holders typically get wiped out” in current bankruptcy cases).

<sup>82</sup> U.S.C. § 1122 (permitting similar claims to be classified in the same class). Admittedly, the process of enforcing absolute priority under Chapter 11 is not perfect. Several ingenious alternative procedures have been proposed to improve on current practice but they have not yet been tested. *See, e.g.*, Philippe Aghion et al., “The Economics of Bankruptcy Reform,” 8 *Journal of Law, Economics and Organization* 523 (1992) (auction involving options); Lucian A. Bebchuk, “A New Approach to Corporate Reorganization,” 101 *Harvard Law Review* 775 (1988) (options-based alternative to Chapter 11).

<sup>83</sup> We discuss the extent to which sovereigns should be permitted to tailor the sovereign bankruptcy framework in detail *infra* in the section entitled

“Should Designer SDRMs Be Permitted?” Tailoring is clearly appropriate in the context of specific voting rules.

<sup>84</sup> For an argument that Chapter 11’s voting rules have this effect, see Skeel, *supra* note 76, at 480, n.69 (analogizing the effect to the predictions of median voter theory).

<sup>85</sup> Jeromin Zettelmeyer, IMF, “The Case for an Explicit Seniority Structure in Sovereign Debt” (September 29, 2003) (unpublished working paper, on file with authors).

<sup>86</sup> See Eugene F. Fama and Merton H. Miller, *The Theory of Finance*, at 150–52 (Holt Rinehart & Winston, 1972); Alan Schwartz, “Security Interests and Bankruptcy Priorities: A Review of Current Theories,” 10 *Journal of Legal Studies* 1 (1981); Clifford W. Smith, Jr., and Jerold B. Warner, “On Financial Contracting: An Analysis of Bond Covenants,” 7 *Journal of Financial Economics* 117 (1979); Michelle J. White, “Public Policy Toward Bankruptcy: Me-First and Other Priority Rules,” 11 *Bell Journal of Economics* 550 (1980).

<sup>87</sup> As Anna Gelpern notes, this would require foresight and the political will to defer borrowing; Anna Gelpern, “Building a Better Seating Chart for Sovereign Restructurings,” 53 *Emory Law Journal* 1119, at 1149 (2004).

<sup>88</sup> See Barbara Samuels II, “Strengthening Information and Analysis in the Global Financial System: A Concrete Set of Proposals,” UN Doc. ST/ESA/2002/DP.23 (UN Department of Economics and Social Affairs, Discussion Paper No. 23, 2002), <http://www.un.org/esa/esa02dp23.pdf>. The Global Information Clearinghouse, <http://globalclearinghouse.org> (last updated September 15, 2003).

<sup>89</sup> For a brief survey of the existing empirical data, see Skeel, *supra* note 55, at 936, n.66.

<sup>90</sup> 11 U.S.C. 364 (2000).

<sup>91</sup> See *supra* the discussion on debt dilution in the section entitled “Example: Debt Dilution and Overborrowing.”

<sup>92</sup> For a discussion of inefficient lending due to “debt overhang,” see Stewart C. Myers, “Determinants of Corporate Borrowing,” 5 *Journal of Financial Economics* 147 (1977).

<sup>93</sup> For a good discussion of these issues in the corporate bankruptcy context, see George G. Triantis, “A Theory of the Regulation of Debt-in-Possession Financing,” 46 *Vanderbilt Law Review* 901 (1993).

<sup>94</sup> See 11 U.S.C. § 364(c) (providing that “the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt”).

<sup>95</sup> See Judge Peter J. Walsh, “Open Letter from Judge Peter J. Walsh to the Delaware Bankruptcy Bar Regarding First-Day DIP Financing Orders” (April 2, 1998); *reprinted in* Marcus Cole, “‘Delaware Is Not a State’: Are We Witnessing Jurisdictional Competition in Bankruptcy?” 55 *Vanderbilt Law Review* 1845, at 1910, app. A (2002).

<sup>96</sup> In the corporate bankruptcy context, confidence that the court would make an immediate determination on the debtor’s DIP financing was one of the major reasons that many large corporate debtors filed for bankruptcy in Delaware in the 1990s. See, e.g., David A. Skeel, Jr., “Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware,” 1 *Delaware Law Review* 1, at 2 (1998).

<sup>97</sup> See IMF, SDRM Design, *supra* note 3, at 45–47.

<sup>98</sup> This problem is closely related to the problem of holding a creditor vote to determine whether to impose a stay on litigation, which we discussed earlier. See *supra* the discussion in the section entitled “Half a Loaf: The IMF’s Proposed Bankruptcy Framework.”

<sup>99</sup> To a certain extent, U.S. courts have begun to develop somewhat analogous distinctions themselves. Most now treat cross-collateralization—that is, the use of collateral to secure not just the new financing by a DIP lender, but also earlier, unsecured obligations owed to the same lender—as presumptively unenforceable. See, e.g., *In re Saybrook Mfg. Co.*, 963 F.2d 1490 (11th Cir. 1992). Our proposal calls for much more stringent restrictions in the sovereign debt context.

<sup>100</sup> The IMF argues that its priority is justified, and must be protected, because it is “not a commercial organization seeking profitable lending opportunities,” lending instead “at precisely the point at which other creditors are reluctant to do so.” Krueger, *supra* note 3, at 11. For a discussion of the current failure to honor the priorities of other creditors, see *supra* notes 9–10, 24 and accompanying text.

In addition to these similarities to a DIP lender, the IMF has another valuable attribute as well. Whereas private creditors tend to focus solely on their own loan, the IMF takes systemic risk into account—a crucially important factor given the risk of contagion when a sovereign debtor defaults. Together, these qualities argue for the IMF to continue serving as the focal point for interim financing during a restructuring.

<sup>101</sup> One might be tempted to argue that, just as a fixed money supply rule is the best guarantee against inflation, an even better guarantee against bailouts is to reduce the budget of the IMF, so that it will not *have* the means to pursue such a policy. But just as a fixed money supply rule has been dismissed as an excessively crude macroeconomic policy, it would be overkill to cut the financial wings of the IMF (or possibly shut it down as some have advocated) just to avoid the still rare occurrence of an excessive bailout.

<sup>102</sup> Interestingly, a more restrictive approach to DIP financing could alleviate a problem that is closely related to the IMF's preference for large lending packages. Because it usually cannot provide all of the financing that its plans call for, the IMF has often required sovereigns to secure additional funds from private lenders in addition to any IMF lending. When the IMF has required the private funds to come first, before it will agree to lend, the results have been quite discouraging. *See, e.g.,* Eichengreen and Ruehl, *supra* note 10, at 27 ("Requiring countries seeking IMF assistance to first raise new money is unrealistic, given the palpable reluctance of investors who do not already have a stake in the crisis country to lend into uncertain conditions."). An SDRM, coupled with limited DIP financing, would avoid these kinds of problems.

<sup>103</sup> As of December, 2003, for example, Peru's current trade debt was US\$3.7 billion, according to World Bank statistics. To put this in perspective, Peru's outstanding bank debt was US\$4 billion: its outstanding bonds totaled US\$2.5 billion, its Brady bonds US\$2.5 billion, and its multilateral debt (that is, debt to other countries) US\$6 billion. World Bank, *Joint BIS-IMF-OECD-World Bank Statistics on External Debt: Peru* (May 28, 2004), <http://www.oecd.org/dataoecd/54/55/31604166.pdf>.

<sup>104</sup> Not surprisingly, the IMF's first sovereign bankruptcy proposals have taken this view. In outlining the IMF's case for an SDRM, for instance, Anne Krueger emphasized that amending the "Fund's Articles [to implement an SDRM] ... would not entail a significant transfer of legal authority to the institution." Especially is this so, she argued, given that "the essential decision-making power would be vested in the debtor and a super-majority of its creditors." Krueger, *supra* note 3, at 9–10.

<sup>105</sup> *See, e.g.,* Samantha Evans, Note, "An FDIC Priority of Claims Over Depository Institution Shareholders," 1991 *Duke Law Journal* 329 (criticizing FDIC assertion of priority over shareholders in pursuing claims against directors and officers). An even bigger complaint was that bank regulators waited too long to declare banks insolvent. For discussion, see

David A. Skeel, Jr., “The Law and Finance of Bank and Insurance Insolvency Regulation,” 76 *Texas Law Review* 723 (1997).

<sup>106</sup> IMF, SDRM Design, *supra* note 3, at 56–70 (proposing a new Sovereign Debt Dispute Resolution Forum that would be “an organ of the Fund” but would “operate ... independently of the Fund’s Executive Board, Board of Governors, management, and staff”); *see also* Benjamin J. Cohen, “A Global Chapter 11,” 75 *Foreign Policy* 109, at 125 (1989) (arguing that a “wholly new and independent entity” should be created, in order “to underscore ... impartiality and objectivity” in the decision-making process).

<sup>107</sup> *See supra* note 42 and accompanying text.

<sup>108</sup> In a proposal that seems to have influenced the IMF’s own recommendation on this issue, Steve Schwarcz argues, for instance, that the International Centre for Settlement of Investment Disputes be used as a model for a new decision-making tribunal; Schwarcz, *supra* note 1, at 1024–30; *see also, id.* at 1024 (suggesting that the jurisdiction of the International Court of Justice could be expanded to include SDRM disputes). A tribunal based on this model would rely on a panel of neutral arbitrators who would “have different nationalities,” and would include “representative[s] of the principal bankruptcy and insolvency law systems of the world.” *Id.* at 1026.

<sup>109</sup> *See* Anthony J. Richards and Mark Gugiatti, *The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers* (July 11, 2003) (unpublished manuscript), <http://ssm.com/abstract=443840>.

<sup>110</sup> U.S. law provides an analogous (though shorter) reachback provision for corporate debtors. The U.S. bankruptcy venue provision permits a corporation to file in the district of its domicile, residence, principal place of business, or principal assets for the majority of the 180 days before bankruptcy. *See* 28 U.S.C. § 1408(1) (2000). In effect, this requires that the venue requirement be met for a minimum of 91 days.

<sup>111</sup> This complaint is a variation of the long-standing criticism of Delaware’s prominence in U.S. corporate law, and its antecedents in the corporate restructuring context date back at least to the 1930s. The classic account of the “race to the bottom” thesis in corporate law is William L. Cary, “Federalism and Corporate Law Reflections Upon Delaware,” 83 *Yale Law Journal* 663 (1974). For a brief history of debates over Delaware’s role in corporate reorganization, including the complaints made during the New Deal era, *see* Skeel, *supra* note 96, at 5–16.

<sup>112</sup> Chicago may also be earning a place on this roster. Prominent recent cases filed in Chicago include the Kmart, United Airlines, and Consec

bankruptcies. *See, e.g.*, Amy Memck, “Chicago Court Adeptly Attracts Chapter 11 Cases,” *Wall Street Journal* (December 10, 2002), at B1.

<sup>113</sup> The most frequent critic has been Lynn LoPucki. *See, e.g.*, Lynn M. LoPucki and Joseph W. Doherty, “Why Are Delaware and New York Bankruptcy Reorganizations Failing?” *55 Vanderbilt Law Review* 1933 (2002); Lynn M. LoPucki and Sara D. Kahn, “The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a ‘Race to the Bottom,’” *54 Vanderbilt Law Review* 231 (2001).

<sup>114</sup> *See* David A. Skeel, Jr., “What’s So Bad About Delaware?” *54 Vanderbilt Law Review* 309, at 315 (2001). Stated differently, creditors’ enthusiasm for Delaware suggests that, to the extent Delaware’s willingness to pay bankruptcy lawyers New York rates was a factor, this cannot be the only reason debtors sought out the Delaware bankruptcy court in the 1990s.

<sup>115</sup> Kenneth M. Ayotte and David A. Skeel, Jr., “Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy,” University of Pennsylvania, Institute for Law and Economics Research Paper No. 03-29, May 2003, <http://ssrn.com/abstractid=463001>.

<sup>116</sup> A related but different question is the issue of how the outcome of the SDRM would be enforced. What would keep the sovereign from simply refusing to honor the terms of the court’s restructuring? The short answer is that the same interests—the desire to retain membership in the IMF and to have access to the credit markets—that induce sovereigns to try to repay their obligations in the first instance would also give them an incentive to honor the terms of the restructuring. Moreover, a sovereign that participated in the SDRM, and proposed a restructuring plan, is particularly unlikely to simply thumb its nose at the outcome.

<sup>117</sup> *See, e.g.*, Buchheit and Gulati. *supra* note 5, at 1334 (describing the waiver trend).

<sup>118</sup> Cross-border insolvency cases pose somewhat similar challenges in the bankruptcy and insolvency context. For a survey of recent efforts by the IMF, World Bank, and other organizations to develop reforms in this area, see, for example, Frederick Tung, “Is International Bankruptcy Possible?” *23 Michigan Journal of International Law* 31 (2001).

<sup>119</sup> *See, e.g.*, Robert K. Rasmussen, “Debtor’s Choice: A Menu Approach to Corporate Bankruptcy,” *71 Texas Law Review* 51 (1992); Robert K. Rasmussen, “Resolving Transnational Insolvencies Through Private Ordering,” *98 Michigan Law Review* 2252 (2000).

<sup>120</sup> Advocates of pure jurisdictional choice for corporate debtors have proposed that debtors who wish to change their selection should be permitted to do so if they hold a vote of all of their creditors and a majority of the creditors approve. *See, e.g.*, Robert K. Rasmussen and Randall S. Thomas, “Timing Matters: Promoting Forum Shopping by Insolvent Corporations,” 94 *Northwestern University Law Review* 1357, at 1399–1402 (2000). The global vote would be quite cumbersome, however—rather like a bankruptcy proceeding in itself—and the effort to switch jurisdictions could have adverse signaling effects for the debtor. *See, e.g.*, Skeel, *supra* note 114, at 328, n.61.

<sup>121</sup> Alan Schwartz has been the principal proponent of bankruptcy contract. *See, e.g.* Alan Schwartz, “A Contract Theory Approach to Business Bankruptcy,” 107 *Yale Law Journal* 1807 (1998).

<sup>122</sup> *See, e.g.* Lynn M. LoPucki, “Contract Bankruptcy: A Reply to Alan Schwartz,” 109 *Yale Law Journal* 317 (1999). For Schwartz’s response, see Alan Schwartz, “Bankruptcy Contracting Revisited,” 109 *Yale Law Journal* 343 (1999).

<sup>123</sup> The illustration in this paragraph develops an application first made in Bolton, *supra* note 14, at 65–66.

<sup>124</sup> For discussion, see David A. Skeel, Jr., *Debt Dominion: A History of Bankruptcy Law in America* (Princeton, N.J.: Princeton University Press, 2001), at 41–42.

<sup>125</sup> *See supra* note 14 and accompanying text.

<sup>126</sup> As suggested in the text, one concern one may have with letting sovereigns opt out of the SDRM with harsher provisions is that, as helpful as these opt-outs are in giving the sovereign credibility up front, they may also in some circumstances lead to inefficient restructuring procedures should the sovereign end up in financial distress. If that is the case, it may be desirable at that point to go back on the opt-out clauses. Of course, if investors anticipate that when push comes to shove these harsher provisions will not be enforced, there will be no point in letting sovereigns opt out in the first place. Clearly, a delicate balancing act is required here, which conceivably the court could be charged with. It could be required to enforce the general principle that, if the circumstances under which the sovereign is led to default on its debt could be reasonably anticipated by investors, then opt-out clauses should be enforced, but if they could not, then the court may allow the sovereign (with possibly some minimal support of creditors) to remove



the harsher provisions or to let debt restructuring to take place under the standard SDRM.

## **IV. FINANCIAL SYSTEM SUPERVISION**

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ROBERT PECK CHRISTEN, TIMOTHY LYMAN, AND  
RICHARD ROSENBERG

Many developing countries and countries with transitional economies are considering whether and how to regulate microfinance. Experts working on this topic do not agree on all points, but there is a surprisingly wide area of consensus. The authors believe that the main themes of this chapter would command general agreement among most of the specialists with wide knowledge of past experience and current developments in microfinance regulation. The document was prepared in consultation with a wide range of such specialists, and has been officially endorsed by a consortium of 29 international agencies that fund microfinance.

This chapter provides useful guidance not only to the staff of the international donors who encourage, advise, and support developing- and transitional-country governments, but also to the national authorities who must make the decisions, and the practitioners and other local stakeholders who participate in the decision-making process and live with the results. On some questions, experience justifies clear conclusions that will be valid everywhere with few exceptions. On other points, the experience is not clear, or the answer depends on local factors, so that no straightforward prescription is possible. On these latter points, the discussion will suggest frameworks for contemplating the issues and identify some factors that need special consideration before reaching a conclusion.

The first section of the paper discusses terminology and preliminary issues. The second section outlines areas of regulatory concern that do not call for “prudential” regulation (see the definition and discussion below). The third section discusses prudential treatment of microfinance and microfinance institutions (MFIs). The fourth section

briefly looks at the challenges surrounding supervision, and the final section summarizes some key policy recommendations.

## **Terminology and Preliminary Issues**

### **What Is “Microfinance”?**

As used in this chapter, the term “microfinance” means the provision of banking services to lower-income people, especially the poor and the very poor. Definitions of these groups vary from country to country. The term “microfinance” is often used in a much narrower sense, referring principally to microcredit<sup>1</sup> for tiny informal businesses of micro entrepreneurs, delivered using methods developed since 1980 mainly by socially oriented nongovernmental organizations (NGOs). This discussion will use “microfinance” more broadly.

The clients are not just micro entrepreneurs seeking to finance their businesses, but the whole range of poor clients who also use financial services to manage emergencies, acquire household assets, improve their homes, smooth consumption, and fund social obligations. The services go beyond microcredit. Also included are savings and transfer services.<sup>2</sup> The range of institutions goes beyond NGOs and includes commercial banks, state-owned development banks, financial cooperatives, and a variety of other licensed and unlicensed nonbank institutions.

Varying terminology used in the discussion of microfinance regulation sometimes leads to confusion. This chapter uses the general definitions as set out in Box 1.

### **Prudential vs. Non-Prudential Regulation and Enabling Regulation**

Regulation is “prudential” when it is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions. When a deposit-taking institution becomes insolvent, it cannot repay its depositors, and—if it is a large institution—its failure could undermine public confidence enough so that the banking system suffers a run on deposits. Therefore, prudential regulation involves the government in overseeing

## **Box 1. Vocabulary of Microfinance Regulation and Supervision**

**Microfinance institution or MFI**—A formal organization whose primary activity is microfinance.

**Regulation**—Binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations).

**Regulations**—The subset of regulation adopted by an executive body, such as a ministry or a central bank.

**Banking law or regulations**—For the sake of simplicity, the chapter uses “banking” in this context to embrace existing laws or regulations for nonbank financial institutions as well.

**Prudential regulation/supervision**—Regulation or supervision is prudential when it governs the financial soundness of licensed intermediaries’ businesses, in order to prevent financial system instability and losses to small, unsophisticated depositors.

**Supervision**—External oversight aimed at determining and enforcing compliance with regulation. For the sake of simplicity, “supervision” in this chapter refers only to prudential supervision.

**Financial intermediation**—The process of accepting repayable funds (such as funds from deposits or other borrowing) and using these to make loans.

**License**—Formal governmental permission to engage in financial service delivery that will subject the license-holding institution to prudential regulation and supervision.

**Permit**—Formal governmental permission to engage in non-depository microlending activity that will not subject the permit-holding institution to prudential regulation and supervision.

**Self-regulation/supervision**—Regulation or supervision by a body that is effectively controlled by the entities being regulated or supervised.

the financial soundness of the regulated institutions: such regulation aims at ensuring that licensed institutions remain solvent or stop collecting deposits if they become insolvent. This concept is emphasized because great confusion results when regulation is discussed without distinguishing between prudential and non-prudential issues.<sup>3</sup>

Prudential regulation is generally much more complex, difficult, and expensive than most types of non-prudential regulation. Prudential regulations (for instance, capital adequacy norms or reserve and liquidity requirements) almost always require a specialized financial authority for their implementation, whereas non-prudential regulation (for instance, disclosure of effective interest rates or of the individuals controlling a company) may often be largely self-executed and can often be dealt with by other than the financial authorities. Thus, an important general principle is to avoid using burdensome prudential regulation for non-prudential purposes—that is, purposes other than protecting depositors’ safety and the soundness of the financial sector as a whole. For instance, if the concern is only to keep persons with bad records from owning or controlling MFIs, the central bank does not have to take on the task of monitoring and protecting the financial soundness of MFIs. It would be sufficient to require registration and disclosure of the individuals owning or controlling them, and to submit proposed individuals to a “fit and proper” screening.

Some non-prudential regulation can be accomplished under general commercial laws and administered by whatever organs of government implement those laws depending on the relative capacity of those agencies. Even where it has hundreds of thousands of customers, microfinance today seldom accounts for a large enough part of a country’s financial assets to pose serious risk to the overall banking and payments systems. Thus, the rest of this discussion assumes that at present the main justification of prudential regulation of depository microfinance is protection of those who make deposits in MFIs. (On the other hand, the development of the microfinance is not static. Wherever depository microfinance reaches significant scale in a particular region or country, systemic risk issues must be taken into consideration, in addition to depositor protection issues. The failure of a licensed MFI with relatively small assets but huge numbers of customers could be contagious for other MFIs.)

Certain regulation is aimed at correcting perceived abuses in an existing industry. Other regulation is “enabling”: its purpose is a positive one—to allow the entry of new institutions or new activities. Most of the microfinance regulation being proposed today is enabling. But what is the activity being enabled? If the purpose is to enable MFIs to take deposits from the public, then prudential regulation is generally called for, because the return of depositors’ money cannot be guaranteed unless the MFI as a whole is financially solvent. If, on the other hand, the regulation’s purpose is to enable certain institutions to conduct a *lending* business legally, then there is usually no reason to assume the burden of prudential regulation, because there are no depositors to protect.<sup>4</sup>

The general discussion of microfinance regulation worldwide tends to emphasize prudential issues—how to enable MFIs to take deposits. However, in some countries, especially formerly socialist transitional economies, the most pressing issues are non-prudential—how to enable MFIs to lend legally.

### **Regulation as Promotion**

For some, the main motivation for regulatory change is to encourage formation of new MFIs and/or improve performance of existing institutions. In the case of both prudential and non-prudential regulation, providing an explicit regulatory space for microfinance may very well have the effect of increasing the volume of financial services delivered and the number of clients served. The right type of non-prudential regulation can frequently have the desired promotional effect with relatively low associated costs.<sup>5</sup> In the case of prudential regulation, however, experience to date suggests that opening up a new, less burdensome regulatory option—particularly if existing MFIs are not yet strong candidates for transformation—can sometimes result in a proliferation of under-qualified depository institutions and create a supervisory responsibility that cannot be fulfilled. In several countries, a new prudential licensing window for small rural banks resulted in many new institutions providing service to areas previously without access, but supervision proved much more difficult than anticipated. As many as half of the new banks turned out to be unsound, and the central bank had to devote excessive resources to cleaning up the situation. Nevertheless, many of the new banks remained to provide rural services. Whether the final outcome was



worth the supervisory crisis is a balancing judgment that would depend on local factors and priorities.

Any discussion of providing an explicit new regulatory space in order to develop the microfinance sector and improve the performance of existing MFIs should weigh carefully the potential unintended consequences. For instance, the political process of regulatory change can lead to reintroduction or renewed enforcement of interest rate caps.<sup>6</sup> In addition, over-specific regulation can limit innovation and competition.

### **“Special Windows” and Existing Financial Regulation**

Discussion and advocacy regarding microfinance regulation often focuses on whether or how to establish a “special window”—that is, a distinct form of license and/or permit—for microfinance. The range of regulatory approaches possible, whether or not they are understood as special windows for microfinance, is limited. It is important to be clear about which of these is being pursued:

- enabling nonbank microlending institutions, which should not require prudential regulation and supervision;
- enabling nonbank financial intermediaries taking retail deposits, which generally does require prudential treatment; or
- enabling a combination of these two.

If a new special window is to be established, should it be done by amendment of the existing financial sector laws and regulations, or should separate legislation or regulation be proposed? As a general proposition, incorporation within the existing framework will better promote integration of the new license and/or permit into the overall financial system. This approach may increase the likelihood that the regulatory changes are properly harmonized with the existing regulatory landscape. Inadequate attention to harmonization has often led to ambiguities about how the various pieces of regulation fit together. Moreover, adjusting the existing framework may be technically easier, and may be more likely to facilitate the entry of existing financial institutions into microfinance. However, local factors will determine the feasibility of this approach. In some countries, for example, policymakers may be reluctant to open up the banking law for amend-

ment because it would invite reconsideration of a whole range of banking issues that have nothing to do with microfinance.

### **Regulatory Arbitrage**

In any event, the content of the regulation involved is likely to be more important than whether it is implemented within existing laws and regulations, or whether it is specifically designated as new “microfinance regulation.” In either case—but particularly if new categories of institution are added to the regulatory landscape—critical attention must be paid to the interplay between the new rules and the ones already in place. If the new rules appear to establish a more lightly or favorably regulated environment, many existing institutions and new market entrants may contort to qualify as MFIs. Such regulatory arbitrage can leave some institutions under-regulated.

Several countries have carefully crafted a special regulatory window for socially oriented microfinance, only to find that the window is later used by types of businesses that are very different from what the framers of the window had in mind. This is particularly the case with consumer lending, which generally goes to salaried workers rather than self-employed micro entrepreneurs. In some cases, these lenders could easily have gotten a banking license, but they opted to use the microfinance window instead because minimum capital and other requirements were less stringent.

### **Non-Prudential Regulatory Issues**

Most of the current discussion of microfinance regulation focuses on prudential regulation. Nevertheless, the present discussion will treat non-prudential issues first, to underscore the point that there are many regulatory objectives that do not require prudential treatment.

Non-prudential (“conduct of business”) regulatory issues, relevant to microfinance, span a wide spectrum. These issues include enabling the formation and operation of microlending institutions; protecting consumers; preventing fraud and financial crimes; setting up credit information services; supporting secured transactions; developing policies with respect to interest rates; setting limitations on foreign ownership, management, and sources of capital; identifying tax and accounting issues; and addressing a variety of

crosscutting issues surrounding transformations from one institutional type to another.

### **Permission to Lend**

In some legal systems, any activity that is not prohibited is implicitly permissible. In these countries, an NGO or other unlicensed entity has an implicit authorization to lend as long as there is no specific legal prohibition to the contrary.

In other legal systems, especially in formerly socialist transitional countries, an institution's power to lend—at least as a primary business—is ambiguous unless there is an explicit legal authorization for it to conduct such a business. This ambiguity is particularly common in the case of NGO legal forms. In still other legal systems, only prudentially licensed and regulated institutions are permitted to lend, even if no deposit taking is involved. Where the legal power to lend is either ambiguous or is prohibited to institutions that are not prudentially licensed, a strong justification exists for introducing non-prudential regulation that explicitly authorizes non-depository MFIs to lend. Where the objective is to enable lending by NGOs, modification of the general legislation governing them may be needed.

Regulation of permission to lend should be relatively simple. Sometimes not much more is needed than a public registry and permit-issuing process. The scope of documents and information required for registration and the issuance of a permit should be linked to specific regulatory objectives, such as providing a basis for governmental action in case of abuse<sup>7</sup> and enabling industry performance benchmarking.

### **Consumer Protection**

Two non-prudential consumer-protection issues are particularly relevant to microfinance and are likely to warrant attention in most, if not all, countries: protecting borrowers against abusive lending and collection practices, and providing borrowers with truth in lending—accurate, comparable, and transparent information about the cost of loans.

### ***Protection Against Abusive Lending and Collection Practices***

There is often a concern about protecting microcredit clients against lenders who make loans without enough examination of the borrower's repayment capacity. This can easily lead to borrowers becoming overindebted, resulting in higher defaults for other lenders. In a number of countries, consumer lenders have proved particularly susceptible to this problem, and governments have found it necessary to regulate against such behavior. In addition, there is often concern about unacceptable loan-collection techniques. Regulation in these areas does not necessarily have to be administered by the prudential supervisory authority.

### ***Truth in Lending***

As discussed in the section on interest rate limits, the administrative cost of disbursing and collecting a given amount of portfolio is much higher if there are many tiny loans than if there are a few large loans. For this reason, microlending usually cannot be done sustainably unless the borrowers pay interest rates that are substantially higher than the rates banks charge to their traditional borrowers. Moreover, different combinations of transaction fees and interest-calculation methods can make it difficult for a borrower to compare interest rates of lenders. In many countries, lenders are required to disclose their effective interest rates to loan applicants, using a uniform formula mandated by the government. Should such truth-in-lending rules be applied to microcredit? Microlenders usually argue strongly against such a requirement. It is easy to be cynical about their motives for doing so, and certainly the burden of proof should lie with anyone who argues against giving poor borrowers an additional tool to help them evaluate a loan's cost—especially when this tool will promote price competition. Moreover, the mandated discipline of disclosing effective interest rates may help to focus microlenders on steps they can take to increase their efficiency and thus lower their rates.

So there ought to be a presumption in favor of giving borrowers full and usable information about interest rates. But the issue is not always simple. In many countries, the public prejudice against seemingly exploitative interest rates is very strong. Even where high inter-

est rates on tiny loans make moral and financial sense, it may still prove difficult to defend them when they are subjected to broad (and uninformed) public discussion, or when politicians exploit the issue for political advantage. Microborrowers show again and again that they are happy to have access to loans even at high rates. But if MFIs are required to express their pricing as effective interest rates, then the risk of a public and political backlash becomes greater, and can threaten the ability of microlenders to operate.

Obviously, the seriousness of this risk will vary from one country to another. In some places, this risk can be dealt with through concerted efforts to educate the public and policymakers about why loan charges in microfinance are high, and why access is more important than price for most poor borrowers. But public education of this sort takes significant time and resources and will not always be successful.

### **Fraud and Financial Crime Prevention**

Two types of concern related to fraud and financial crimes predominate in connection with microfinance regulation: (1) concerns about securities fraud and abusive investment arrangements such as pyramid schemes, and (2) money-laundering concerns. In addressing these, the same rules should apply to MFIs as to other economic actors. It should not be assumed automatically that the best body to deal with these concerns is the one responsible for prudential regulation. In many countries, the existing anti-fraud and financial crime regulation will be adequate to address abuse in the case of MFIs, or will need amendment only to add any new categories of institution to the regulatory landscape. Often the most pressing need is to improve enforcement of existing laws.

### **Credit Reference Services**

Credit reference services—called by a variety of names including credit bureaus—offer important benefits both to financial institutions and to their customers. By collecting information on clients' status and history with a range of credit sources, these databases allow lenders to lower their risks, and allow borrowers to use their good repayment record with one institution to get access to new credit from other institutions. Such credit bureaus allow lenders to be much more ag-

gressive in lending without physical collateral, and strengthen borrowers' incentive to repay. Depending on the nature of the database and the conditions of access to it, credit information can also have a beneficial effect on competition among financial service providers.

In developed countries, the combination of credit bureaus and statistical risk-scoring techniques has massively expanded the availability of credit to lower-income groups. In developing countries, especially those without a national identity-card system, practical and technical challenges abound, but new technologies (such as thumb-print readers and retinal scanners) may offer solutions. Experience suggests that when MFIs begin to compete with each other for customers, overindebtedness and default will rise sharply unless the MFIs have access to a common database that captures relevant aspects of their clients' borrowing behavior. Does the government need to create a credit bureau or require participation in it? The answer will vary from country to country. A common pattern in developing countries is that merchants participate voluntarily in private credit bureaus, but bankers are more reluctant to share customer information unless the law requires them to do so.

Especially when banks participate in them, credit information services raise privacy issues. Sometimes these issues can be handled simply by including in loan contracts the borrowers' authorization for the lender to share information on their credit performance with other lenders. In other circumstances, laws will need to be amended.

Credit information services can provide clear benefits, but such data collection can entail risks. Corrupt database managers may sell information to unauthorized parties. Tax authorities may want to use the database to pursue unregistered microenterprises. Borrowers can be hurt by inaccurate information in the database, although guaranteeing them access to their own credit histories can lower this risk.

For donors wanting to help expand access to financial services for both poor and middle-class people, development of private or public credit information systems that include microborrowers could be an attractive target of support in countries where the conditions are right. Among these conditions are a national identity system or some other technically feasible means of identifying clients, a fairly mature market of MFIs or other firms that lend to low-income borrowers, and a

legal framework that creates the right incentives for participation as well as protecting fairness and privacy.

### **Secured Transactions**

Borrowers, lenders, and the national economy all benefit when not only real estate but also moveable assets can be pledged as collateral for loans. But in many developing and transitional economies, it is expensive or impossible to create and enforce a security interest in moveable collateral. Sometimes there are also constraints that make it hard for lower-income people to use their homes and land as collateral. Legal and judicial reform to support secured transactions can be very worthwhile, although these matters tend to affect the middle class more than they do the poor. Such reform typically centers on the commercial and judicial laws, not the banking law.

### **Interest Rate Limits**

To break even, lenders need to set loan charges that will cover their cost of funds, their loan losses, and their administrative costs. The cost of funds and of loan loss varies proportionally to the amount lent. But administrative costs do not vary in proportion to the amount lent. One may be able to make a US\$20,000 loan while spending only US\$600 (3 percent) in administrative costs; but this does not mean that administrative costs for a US\$200 loan will be only US\$6. In comparison with the amount lent, administrative costs are inevitably much higher for microcredit than for conventional bank loans.<sup>8</sup> Thus, MFIs cannot continue to provide tiny loans unless their loan charges are considerably higher in percentage terms than normal bank rates.

Legislatures and the general public seldom understand this dynamic, so they tend to be outraged at microcredit interest rates even in cases where those rates reflect neither inefficiency nor excessive profits.<sup>9</sup> Therefore, if the government takes on control of microcredit interest rates, practical politics will usually make it difficult to set an interest rate cap high enough to permit the development of sustainable microcredit. Interest rate caps, where they are enforced, almost always hurt the poor—by limiting services—far more than they help the poor by lowering rates.

Some international donors assume too easily that the argument over high interest rates for microcredit has been won. But recently there have been backlashes in many countries. Before donors and governments commit to building an enabling regulatory framework for microfinance, they need to consider the possibility that the process may unavoidably entail political discussion of interest rates, with results that could damage responsible microcredit. Experience shows that this risk is real, although it is certainly not relevant in all countries.

### **Limitations on Ownership, Management, and Capital Structure**

In many legal systems, citizenship, currency, and foreign-investment regulations create hurdles for some forms of MFI. Common problems include prohibitions or severe limitations on the participation of foreign-equity holders (or founders or members in the case of NGOs), borrowing from foreign sources, and employment of noncitizens in management or technical positions. In many countries, the microfinance business will not attract conventional commercial investors for some years yet. Since alternative sources of investment—particularly equity investment—tend to be international, limitations on foreign investment can be especially problematic.<sup>10</sup>

### **Tax and Accounting Treatment of Microfinance**

Taxation of MFIs is becoming a controversial topic in many countries. Local factors may call for differing results, but the following approach is suggested as a starting point for the analysis. It is based on a distinction between taxes on financial transactions and taxes on net profits arising from such transactions.

#### ***Taxation of Financial Transactions and Activities***

With respect to taxes on financial transactions, such as a value-added tax on lending or a tax on interest revenue, the critical issue is a level playing field among institutional types. In some countries, favorable tax treatment on transactions is available only to prudentially licensed institutions, even though the favorable tax treatment bears no substantive relationship to the objectives of prudential regulation. In other countries, financial-transaction taxes affect financial cooperatives differently from banks. Absent other considerations, favorable



transaction tax treatment should be based on the type of activity or transaction, regardless of the nature of the institution and whether it is prudentially licensed. To do otherwise gives one form of institution an arbitrary advantage over another in carrying out the activity.

### ***Taxation of Profits***

It can reasonably be argued that not-for-profit NGO MFIs ought to be treated the same as all other public-benefit NGOs when the tax in question is a tax on net profits. The reason for exemption from profits tax is the principle that the NGO is rendering a recognized public benefit and does not distribute its net surpluses into the pockets of private shareholders or other insiders. Rather, it reinvests any surplus to finance more socially beneficial work. To be sure, there are always ways to evade the spirit of this nondistribution principle, such as excessive compensation and below-market loans to insiders. However, these potential abuses probably occur no more commonly in NGOs engaged in microlending than in other types of NGOs.

For any institution subject to a net income or profits tax, rules for tax deductibility of expenses (such as reasonable provisioning for bad loans) should apply consistently to all types of institutions, regardless of whether they are prudentially licensed. Moreover, if it is appropriate to provision a microloan portfolio more aggressively than a conventional loan portfolio, then the microlender's profits tax deduction should also vary accordingly. For licensed institutions, prudential regulation will normally dictate the amount of loan-loss provisioning. In the case of unlicensed lending-only institutions, the tax authorities may need to regulate allowable amounts of provisioning in order to prevent abuse.

### **Feasible Mechanisms of Legal Transformation**

Legal transformations in microfinance—from one institutional type to another—raise a variety of crosscutting non-prudential regulatory issues. The simplest and most common type of transformation occurs when an existing MFI operation is transferred to the local office of an international NGO as a new, locally formed NGO. Such a transfer can face serious regulatory obstacles, including limits on foreign participation, ambiguous or prohibitive taxation of the portfolio

transfer, and labor law issues created by the transfer of staff. A second, increasingly common type of legal transformation involves the creation of a commercial company by an NGO (sometimes together with other investors), to which the NGO contributes its existing portfolio (or cash from the repayment of its portfolio) in exchange for shares in the new company. Such transformations often raise additional issues, including how to recapture or otherwise make allowance for tax benefits that the transforming NGOs have received; restrictions on the NGO's power to transfer what are deemed "charitable assets" (its loans) to a privately owned company; and restrictions on the NGO's power to hold equity in a commercial company, particularly if this will become its principal activity as a result of the transformation.

Ordinarily, these disparate bodies of regulation do not contemplate, and have never been applied to, microfinance transformations. Harmonizing their provisions and creating a clear path for microfinance transformations can be an important enabling reform. On the other hand, such reform may be a lower priority if there are only one or two microfinance NGOs who are likely candidates for transformation.<sup>11</sup>

## **Prudential Regulation of Microfinance**

### **Objectives of Prudential Regulation**

The generally agreed objectives of prudential regulation include (1) protecting the country's financial system by preventing the failure of one institution from leading to the failure of others, and (2) protecting small depositors who are not well positioned to monitor the institution's financial soundness themselves. If prudential regulation does not focus closely enough on these objectives, scarce supervisory resources can be wasted, institutions can be saddled with unnecessary compliance burdens, and development of the financial sector can be constrained.

## **Drawing the Line: When to Apply Prudential Regulation in Microfinance?**

### ***Timing and the State of the Industry***

New regulatory windows for microfinance are being considered in many countries today. In a few of these countries, a somewhat paradoxical situation exists. The expectation is that, over the medium term, the new window will be used mainly by existing NGO MFIs that want to change to deposit-taking status. But at the same time, none or almost none of the existing MFIs have yet demonstrated that they can manage their lending profitably enough to pay for and protect the deposits they want to mobilize. In such a setting, the government should consider the option of waiting and monitoring micro-lenders' performance, and open the window only after there is more and better experience with the financial performance of the MFIs. Developing a new regulatory regime for microfinance takes a great deal of analysis, consultation, and negotiation; the costs of the process can exceed the benefits unless a critical mass of qualifying institutions can be expected.

In this context, the actual financial performance of existing MFIs is a crucial element that often gets too little attention in discussions of regulatory reform. Whenever there is an expectation that existing MFIs will take advantage of a new regulatory window, there should be a competent financial analysis of at least the leading MFIs before decisions are made with respect to that window. This analysis should focus on whether each MFI's existing operations are profitable enough so that it can pay the financial and administrative costs of deposit taking without decapitalizing itself. Naturally, this analysis will have to include a determination of whether the MFI's accounting and loan-tracking systems are sound enough to produce reliable information.

### ***Sources of Funding***

Both the objectives of prudential regulation—to prevent risk to the financial system and to protect depositors—are served when retail deposits of the general public are protected. Thus, raising funds from this source will usually call for prudential regulation. Are MFIs that fund their lending from other sources of capital also engaged in finan-

cial intermediation that needs to be prudentially regulated? This question needs close analysis, and its answer will often depend on local factors.<sup>12</sup>

**Donor Grants.** Historically, donors of one type or another, including bilateral and multilateral development agencies, have supported MFIs with grants. The justifications for prudential supervision do not apply in the case of MFIs funded only by donor grants. The government may have an interest in seeing that donor funds are well spent, but microfinance is no different in this respect from any other donor-supported activity.

**Cash Collateral and Similar Obligatory Deposits.** Many MFIs require cash deposits from borrowers before and/or during a loan, in order to demonstrate the borrower's ability to make payments, and to serve as security for the repayment of the loan. Even though these deposits are often called "compulsory savings," it is more useful to think of them as cash collateral required by the loan contract, rather than as a true savings service. This cash collateral is sometimes held by a third party (such as a commercial bank), and thus is not intermediated by the MFI. Even when the MFI holds its clients' obligatory deposits, and even if it intermediates them by lending them out, the question of whether to apply prudential regulation should be approached from the standpoint of practically weighing the costs and benefits. If cash collateral is the only form of deposit taken by the MFI, then most of its customers owe more to the MFI than the MFI owes to them, most of the time. If the MFI fails, these customers can protect themselves by simply ceasing repayment of their loan. It is true that some of the MFI's customers will be in a net at-risk position some of the time, so that the MFI's failure would imperil their deposits, but this relatively lesser risk needs to be weighed against the various costs of prudential supervision—costs to the supervisor, to the MFI, and to the customer. Several countries have taken a middle path on this issue, requiring prudential licensing only for MFIs that hold and intermediate their clients' cash collateral, but not for MFIs that keep such collateral in low-risk securities or in an account with a licensed bank.

**Borrowing from Noncommercial Sources, Including Donors or Sponsors.** Increasingly, donors are using loans rather than grants to support MFIs. Although the loan proceeds are intermediated by the MFI, their loss would pose no substantial systemic risk in the host country, and the lenders are well positioned to protect their own interests if they care to. The definition of deposit taking that triggers prudential regulation should therefore exclude this type of borrowing.

**Commercial Borrowing.** Some MFIs get commercial loans from international investment funds that target social-purpose investments, and from locally licensed commercial banks. Here, too, the fact that commercial loan proceeds are intermediated by the MFI should not lead to prudential regulation of the borrowing MFI. Where the lender is an international investment fund, the loss of its funds will not pose systemic risk, and the lender should be able to look out for its own interests. Where the lender is a locally licensed commercial bank, it should itself already be subject to appropriate prudential regulation, and the fact that an MFI borrows from the bank does not justify prudential regulation of the MFI any more than would be the case for any other borrower from the bank.<sup>13</sup>

**Wholesale Deposits and Deposit Substitutes.** In some countries, MFIs can finance themselves by issuing commercial paper, bonds, or similar instruments in the local securities markets. Similar issues are presented by the direct issuance of large certificates of deposit. Unlike deposits from the general public, all these instruments tend to be bought by large, sophisticated investors. There is not a consensus on how to regulate such instruments. Some argue that the buyers of these instruments ought to be able to make their own analysis of the financial soundness of the issuing business. Therefore, they would subject the issuer only to normal securities regulation, which generally focuses on insuring complete disclosure of relevant information, rather than giving any assurance as to the financial strength of the issuer. Others, less impressed by the distinction between wholesale and retail deposits—or skeptical about the local securities law and enforcement—insist that any institution issuing such instruments and intermediating the funds be prudentially regulated.

**Members' Savings.** Much of the current discussion of microfinance regulation focuses, implicitly or explicitly, on NGO MFIs that have begun with a credit-based model and now want to move to capturing deposits. But in large parts of the world, most microfinance is provided by financial cooperatives that typically fund their lending from members' share deposits and savings. It is sometimes argued that, because these institutions take deposits only from members and not from "the public," they need not be prudentially supervised. This argument is problematic. In the first place, when a financial cooperative becomes large, its members as a practical matter may be in no better a position to supervise management than are the depositors in a commercial bank. Secondly, the boundaries of membership can be porous. For instance, financial cooperatives whose common bond is geographical can capture deposits as extensively as they want by the simple expedient of automatically giving a membership to anyone in their area of operations who wants to make a deposit.

Often such financial cooperatives are licensed under a special law, and their supervision may be lodged in the government agency that supervises all cooperatives, including cooperatives focused on production, marketing, and other nonfinancial activities. While these agencies may be legally responsible for prudential supervision of the safety of depositors, they almost never have the resources, expertise, and independence to do that job effectively. Absent strong local reasons to the contrary, financial cooperatives—at least large ones—should be prudentially supervised by a specialized financial authority. In countries with a large existing base of financial cooperatives, securing effective regulation and supervision of these cooperatives may be a more immediate priority than developing new windows for NGO microfinance.

### ***Rationing Prudential Regulation Through Minimum Capital Requirements***

As discussed below, prudential supervision is expensive. When measured as a percentage of assets supervised, these expenses are higher for small institutions than for large ones. Furthermore, supervisory authorities have limited resources. As a practical matter, there is a need to ration the number of financial licenses that will require supervision. The most common tool for this rationing is a minimum

capital requirement—the lowest amount of currency that owners can bring to the equity account of an institution seeking a license.

In theory, setting of minimum capital could be based on economies of scale in financial intermediation: in other words, below a certain size, an intermediary cannot support the minimum necessary infrastructure and still operate profitably. However, there is an increasing tendency to downplay the utility of minimum capital as a safety measure and instead to treat it more straightforwardly as a rationing tool. The lower the minimum capital, the more entities will have to be supervised.

Those who see regulation of microfinance primarily as promotion will want low minimum-capital requirements, making it easier to obtain new licenses. On the other hand, supervisors who will have to oversee the financial soundness of new deposit-taking institutions tend to favor higher capital requirements, because they know there are limits on the number of institutions they can supervise effectively. To put the point simply, there is a trade-off between the number of new institutions licensed and the likely effectiveness of the supervision they will receive. The most common tool for drawing the balance is minimum capital.

However, minimum capital is not necessarily the only tool available to limit new market entrants. For example, licensing decisions can be based in part on qualitative institutional assessments—though qualitative standards leave more room for abuse of official discretion.<sup>14</sup>

Whatever rationing tools are used, it would seem reasonable to err on the side of conservatism at first, as long as the requirements can be adjusted later, when the authorities have more experience with the demand for licenses and the practicalities of microfinance supervision. Obviously, such flexibility is easier if the requirements are placed in regulations rather than in the law.

***Drawing Lines Based on Cost-Benefit Analysis—The Case of Small Community-Based Intermediaries***

Some member-owned intermediaries take deposits but are so small, and sometimes so geographically remote, that they cannot be supervised on any cost-effective basis. This poses a practical problem for the regulator. Should these institutions be allowed to operate without prudential supervision, or should minimum-capital or other requirements be enforced against them so that they have to cease taking deposits?

Sometimes regulators are inclined to the latter course. They argue that institutions that cannot be supervised are not safe, and therefore should not be allowed to take small depositors' savings.<sup>15</sup> After all, are not small and poor customers just as entitled to safety as large and better-off customers?

But this analysis is too simple if it does not consider the actual alternatives available to the depositor. Abundant studies show that poor people can and do save. Especially when formal deposit accounts are not available, they use savings tools, such as currency under the mattress, livestock, building materials, or informal arrangements like rotating savings and credit clubs. All of these vehicles are risky, and in many if not most cases, they are more risky than a formal account in a small unsupervised intermediary. Closing down the local savings and loan cooperative may in fact raise, not lower, the risk faced by local savers by forcing them back to less satisfactory forms of savings.

Because of these considerations, most regulators facing the issue have chosen to exempt community-based intermediaries below a certain size from requirements for prudential regulation and supervision. The size limits are determined by number of members, amount of assets, or both. (Sometimes the exemption is available only to "closed bond" institutions whose services are available only to members of a preexisting group.) Once the limits are exceeded, the institution must comply with prudential regulation and be supervised.

If small intermediaries are allowed to take deposits without prudential supervision, a good argument can be made that their customers should be clearly advised that no government agency is monitor-



ing the health of the institution, and thus that they need to form their own conclusions based on their knowledge of the individuals running the institution.

These issues presented by very small intermediaries illustrate a more general principle that applies to many of the topics discussed in this chapter. Depositor protection is not an absolute value that overrules all other considerations. Some rules that lower risk can also lower poor people's access to financial services, an equally important value. In such cases, the regulator's objective should be, not the elimination of risk, but rather a prudent balancing of safety and access.

### **Regulate Institutions or Activities?**

When trying to open up regulatory space for microfinance, there is a natural tendency to think in terms of creating a new, specialized institutional type. In some settings this is the best option. But alternatives should be considered, including the possibility of fine-tuning an existing form of financial license. There is some danger that too exclusive a focus on a particular institutional form may cramp innovation and competition, encourage regulatory arbitrage, or impede the integration of microfinance into the broader financial sector.

These considerations lead some in the field to argue that policymakers should focus more on regulating microfinance as a set of activities, regardless of the type of financial institution carrying them out, and less on particular institutional forms. This is a healthy emphasis. The following section discusses special regulatory adjustments needed for microfinance; almost all of these adjustments would be applicable no matter what type of institution is doing microfinance. At the same time, a few of the necessary regulatory adjustments will have to do with the type of institution rather than the activity itself. For instance, microlending arguably presents a lower risk profile when it is a small part of the portfolio of a diversified full-service bank, compared to microlending that constitutes the majority of a specialized MFI's assets; thus, it can reasonably be argued that these two institutional types ought to be subject to different capital-adequacy rules.

## **Special Prudential Standards for Microfinance**

Some regulations common in traditional banking need to be adjusted to accommodate microfinance. Whether microfinance is being developed through specialized stand-alone depository MFIs, or as product lines within retail banks or finance companies, the following sets of regulations will commonly need reexamination, at least for those products that can fairly be categorized as “micro.” Other rules may require adjustment in some countries, but the list below includes the most common issues.

### ***Minimum Capital***

The kind of investors who are willing and able to finance MFIs may not be able to come up with the amount of capital required for a normal bank license. Furthermore, it might take a specialized MFI a long time to build a portfolio large enough to leverage adequately the amount of equity required for a bank. The trade-offs involved in setting minimum capital requirements for microfinance were discussed previously in the section “Rationing Prudential Regulation Through Minimum Capital Requirements.”

### ***Capital Adequacy***

There is controversy as to whether the capital-adequacy requirements for specialized MFIs should be tighter than the requirements applied to diversified commercial banks.<sup>16</sup> A number of factors argue in the direction of such conservatism.

Well-managed MFIs maintain excellent repayment performance, with delinquency typically lower than in commercial banks. However, an MFI portfolio tends to be more volatile than a commercial bank portfolio, and can deteriorate with surprising speed. The main reason for this is that a microfinance portfolio is usually unsecured, or secured by assets that are insufficient to cover the loan, once collection costs are included. The borrower’s main incentive to repay a microloan is the expectation of access to future loans. Thus, outbreaks of delinquency in an MFI can be contagious. When a borrower sees that others are not paying back their loans, that borrower’s own incentive to continue paying declines, because the outbreak of delinquency makes it less likely that the MFI will be able to reward the borrower’s

faithfulness with future loans. Peer dynamics play a role as well: when borrowers have no collateral at risk, they may feel foolish paying their loans when others are not.

In addition, because their costs are high, MFIs need to charge high interest rates to stay afloat. When loans are not being paid, the MFI is like any bank in that it is not receiving the cash it needs to cover the costs associated with those loans. However, the MFI's costs are usually much higher than a commercial bank's costs per unit lent, so that a given level of delinquency will decapitalize an MFI much more quickly than it would decapitalize a typical bank.

Another relevant factor is that in most countries, neither microfinance as a business nor individual MFIs as institutions have a very long track record. Management and staff of the MFIs tend to be relatively inexperienced, and the supervisory agency has little experience with judging and controlling microfinance risk. Furthermore, many new MFIs are growing very fast, which puts heavy strain on management and systems.

Finally, as will be discussed below, some important supervisory tools do not work very well for specialized MFIs. For all these reasons, a prudent conservatism would seem to suggest that specialized MFIs be subject to a higher capital-adequacy percentage than is applied to normal banks, at least until some years of historical performance have demonstrated that risks can be managed well enough, and that the supervisor can respond to problems quickly enough, so that MFIs can then be allowed to leverage as aggressively as commercial banks.

Others argue that applying a higher capital-adequacy requirement to MFIs, or an equivalent risk-weighting requirement to microloan portfolios in diversified institutions, will tend to lower the return on equity in microlending, thus reducing its attractiveness as a business and creating an uneven playing field. On the other hand, the demand for microfinance is less sensitive to interest rates than is the demand for normal bank loans, so that microlenders have more room to adjust their interest-rate spread to produce the return they need, as long as all microlenders are subject to the same rules and the government does not impose interest rate caps.

Applying capital-adequacy norms to financial cooperatives presents a specific issue with respect to the definition of capital. All members of such cooperatives are required to invest a minimum amount of “share capital” in the institution. But unlike an equity investment in a bank, a member’s share capital can usually be withdrawn whenever the member decides to leave the cooperative. From the vantage of institutional safety, such capital is not very satisfactory: it is impermanent, and is most likely to be withdrawn at precisely the point when it would be most needed—when the cooperative gets into trouble. Capital built up from retained earnings, sometimes called “institutional capital,” is not subject to this problem. One approach to this issue is to limit members’ rights to withdraw share capital if the cooperative’s capital adequacy falls to a dangerous level. Another approach is to require cooperatives to build up a certain level of institutional capital over a period of years, after which time capital adequacy is based solely on these retained earnings.

### ***Unsecured Lending Limits and Loan-Loss Provisions***

In order to minimize risk, regulations often limit unsecured lending to some percentage—often 100 percent—of a bank’s equity base. Such a rule should not be applied to microcredit because it would make it impossible for an MFI to leverage its equity with deposits or borrowed money.

Bank regulations sometimes require 100-percent loan-loss provisions for all unsecured loans at the time they are made, even before they become delinquent. However, this is unworkable when applied to microcredit portfolios. Even if the provision expense is later recovered when a loan is collected, the accumulated charge for current loans would produce a massive underrepresentation of the MFI’s real net worth.

To meet these two problems, a common regulatory adjustment is to treat group guarantees as “collateral” for purposes of applying such regulations to microcredit. This can be a convenient solution to the problem if all microlenders use these guarantees. However, group guarantees are less effective than is often supposed. Many MFIs do not enforce these guarantees, and there is no evidence that group-guaranteed microloans have higher repayment rates than nonguaranteed individual microloans. The most powerful source of

security in microcredit tends to be the strength of an institution's lending, tracking, and collection procedures, rather than the use of group guarantees.

Whatever the rationale used to justify the adjustment, competent lenders should not be required to automatically provision large percentages of microcredit loans as soon as they are made. But once such loans have fallen delinquent, the fact that they are unsecured justifies requiring them to be provisioned more aggressively than conventionally collateralized portfolio. This is especially true in countries where microlending tends to be short term. After 60 days of delinquency, a three-month unsecured microloan with weekly scheduled payments presents a higher likelihood of loss than does a two-year loan secured by real estate and payable monthly.

In some countries, MFIs are effectively prevented from borrowing from banks because the MFIs cannot offer qualifying collateral, and without such collateral the bank would have to provision 100 percent of the loan. In such countries, consideration should be given to adjusting the banking rules so that the loan portfolio of an MFI with a strong track record of collection can qualify as collateral for a bank loan.

### ***Loan Documentation***

Given the nature of microfinance loan sizes and customers, it would be excessive or impossible to require them to generate the same loan documentation as commercial banks. This is particularly true, for instance, with collateral registration, financial statements of borrowers' businesses, or evidence that those businesses are formally registered. These requirements must be waived for micro-sized loans. On the other hand, some microlending methodologies depend on the MFI's assessment of each borrower's repayment ability. In such cases, it is reasonable to require that the loan file contain simple documentation of that assessment of the client's cash flow. However, when it makes repeated short-term (for instance, three-month) loans to the same customer, the MFI should not be required to repeat the cash-flow analysis for every single loan.

### ***Restrictions on Cosigners as Borrowers***

Regulations sometimes prohibit a bank from lending to someone who has co-signed or otherwise guaranteed a loan from that same bank. This creates problems for institutions using group-lending mechanisms that depend on all group members co-signing each others' loans.

### ***Physical Security and Branching Requirements***

Banks' hours of business, location of branches, and security requirements are often strictly regulated in ways that could impede service to a microfinance clientele. For instance, client convenience might require operations outside normal business hours, or cost considerations might require that staff rotate among branches that are open only one or two days a week. Security requirements such as guards or vaults, or other normal infrastructure rules, could make it too costly to open branches in poor areas. Branching and physical security requirements merit reexamination—but not necessarily elimination—in the microfinance context. Clients' need for access to financial services has to be balanced against the security risks inherent in holding cash.

### ***Frequency and Content of Reporting***

Banks may be required to report their financial position frequently—even daily. In many countries, the condition of transportation and communication can make this virtually impossible for rural banks or branches. More generally, reporting to a supervisor (or a credit information service) can add substantially to the administrative costs of an intermediary, especially one that specializes in very small transactions. Reporting requirements should usually be simpler for microfinance institutions or programs than for normal commercial bank operations.

### ***Reserves Against Deposits***

Many countries require banks to maintain reserves equal to a percentage of certain types of deposits. These reserves may be a useful tool of monetary policy, but they amount to a tax on savings, and can squeeze out small depositors by raising the minimum deposit size that

banks or MFIs can handle profitably. This latter drawback should be factored into decisions about reserve requirements.

### ***Ownership Suitability and Diversification Requirements***

The typical ownership and governance structure of MFIs tends to reflect their origins and initial sources of capital.<sup>17</sup> NGOs, governmental aid agencies, multilateral donors, and other development-oriented investors predominate over those who have the profit-maximizing objectives of typical bank shareholders. The individuals responsible for these development-oriented investments are usually not putting at risk money from their own private pockets. Investors of this kind, and their elected directors, may have weaker personal incentives to monitor the risk-taking behavior of MFI management closely. This does not imply that private, profit-maximizing owners of commercial banks always do a good job of supervising commercial bank management. But experience does indicate that such owners tend on average to watch the management of their investments more carefully than do the representatives of donors and social investors.

Typical banking regulation mandates the nature of permissible shareholders, as well as the minimum number of founding shareholders and a maximum percentage of ownership for any shareholder. Both types of rules can pose obstacles for depository MFIs, given their ownership and governance attributes.

These rules serve legitimate prudential objectives. Mandates as to the nature of permissible shareholders aim to assure that the owners of a depository financial institution will have both the financial capacity and the direct interest to put in additional funds if there is a capital call. Ownership diversification requirements aim at preventing “capture” of bank licenses by single owners or groups, and building checks and balances into governance. But together these requirements can cause serious problems in the common case, where the assets of the new licensed MFI come almost entirely from the NGO that has been conducting the microfinance business until the creation of the new institution.

First, laws or regulations sometimes prohibit an NGO from owning shares in the licensed institution. While such a prohibition may serve a legitimate purpose, it generally poses too heavy an obstacle to

the eventual licensing of microfinance that originated in an NGO: consideration should be given to amending it. Even if the NGO is permitted to own shares of the new institution, diversification requirements may pose an additional challenge. For instance, a five-owner minimum and a 20 percent maximum per shareholder would force the transforming NGO to seek out four other owners whose combined capital contribution would be four times as much as the NGO is contributing. This can be an impractical burden for a socially oriented business whose profitability is not yet strong enough to attract purely commercial equity. The only alternative has sometimes been to distribute shares to other owners who have not paid in an equivalent amount of equity capital. This arrangement does not tend to produce good oversight by the other owners.

Given the legitimate objectives of shareholder suitability and ownership diversification requirements, there is no easy or universal prescription for how to modify these types of rules to accommodate MFIs. However, the solution may in some instances be as simple as permitting the licensing agency the discretion to consider the particular situation of microfinance applicants and their proposed backers, whereby it would waive shareholder suitability and diversification requirements on a case-by-case basis.

### ***To Whom Should These Special Standards Apply?***

It is worth reiterating that most of the adjustments mentioned in this section should ideally apply, not only to specialized MFIs, but also to microfinance operations in commercial banks or finance companies. Some of them are also relevant to unsecured lending by financial cooperatives.

Even if a country's commercial banks have no interest in microfinance at present, those attitudes can change once specialized MFIs credibly demonstrate the profit potential of their business. If a full-service bank decides to offer microfinance products, or to partner with an MFI to offer those products, it should have a clear regulatory path to do so; otherwise, continued fragmentation of the financial sector is guaranteed. Regulators and supervisors should have a special incentive to encourage such developments: when microcredit is a small part of a diversified commercial bank portfolio, the risk and cost of supervising the microfinance activity become much lower.



Moreover, a level playing field in terms of the prudential standards applied to an activity helps to stimulate competition.

### **Deposit Insurance**

In order to protect smaller depositors and reduce the likelihood of runs on banks, many countries provide explicit insurance of bank deposits up to some size limit. Some other countries provide de facto reimbursement of bank depositors' losses even in the absence of an explicit legal commitment to do so. There is considerable debate about whether public deposit insurance is effective in improving bank stability, whether it encourages inappropriate risk taking on the part of bank managers, and whether such insurance would be better provided through private markets. In any event, if deposits in commercial banks are insured, the presumption ought to be that deposits in other institutions prudentially licensed by the financial authorities should also be insured, absent compelling reasons to the contrary.

### **Facing the Supervisory Challenge**

Decades of experience around the world with many forms of “alternative” financial institutions—including various forms of financial cooperatives, mutual societies, rural banks, village banks, and now MFIs—demonstrate that there is a strong and nearly universal temptation to underestimate the challenge of supervising such institutions in a way that will keep them reasonably safe and stable. When the various stakeholders start discussing legal frameworks for microfinance in a country, it is relatively easy and interesting to craft regulations, but harder and less attractive to do concrete practical planning for effective supervision. The result is that supervision sometimes gets little attention in the process of regulatory reform, often on the assumption that whatever supervisory challenges are created by the new regulation can be addressed later, by pumping extra money and technical assistance into the supervisory agency for a while. This assumption can be wrong in many cases. The result may be regulation that is not enforced, which can be worse than no regulation at all.

Microfinance as an industry can never reach its full potential until it is able to move into the sphere of prudentially regulated institutions, where it will have to be prudentially supervised.<sup>18</sup> While prudential

regulation and supervision is inevitable for microfinance, there are choices to be made and balances to be drawn in deciding when, and how, this development takes place. Those balances are likely to be drawn in the right place only if supervisory capability, costs, and consequences are examined earlier and more carefully than is sometimes the case in present regulatory discussions.

The crucial importance of early and realistic attention to supervision issues stems from the fiduciary responsibility the government assumes when it grants financial licenses. Citizens should be able to assume, and usually do assume, that the issuance of a prudential license to a financial intermediary means that the government will effectively supervise the intermediary to protect their deposits. Thus, licenses are promises. Before deciding to issue them, a government needs to be clear about the nature of the promises and about its ability to fulfill them.

### **Supervisory Tools and Their Limitations**

**Portfolio Supervision Tools.** Some standard tools for examining banks' portfolios are ineffective for microcredit. As noted earlier, loan-file documentation is a weak indicator of microcredit risk. Likewise, sending out confirmation letters to verify account balances is usually impractical, especially where client literacy is low. Instead, the examiner must rely more on an analysis of the institution's lending systems and their historical performance. Analysis of these systems requires knowledge of microfinance methods and operations, and drawing practical conclusions from such analysis calls for experienced interpretation and judgment. Supervisory staff are unlikely to monitor MFIs effectively unless they are trained and to some extent specialized.

**Capital Calls.** When an MFI gets in trouble and the supervisor issues a capital call, many MFI owners are not well positioned to respond to it. NGO owners may not have enough liquid capital available. Donors and development-oriented investors usually have plenty of money, but their internal procedures for disbursing it often take so long that a timely response to a capital call is impractical. Thus, when a problem surfaces in a supervised MFI, the supervisor may not be able to get it solved by the injection of new capital.

**Stop-Lending Orders.** Another common tool that supervisors use to deal with a bank in trouble is the stop-lending order, which prevents the bank from taking on further credit risk until its problems have been sorted out. A commercial bank's loans are usually collateralized, and most of the bank's customers do not necessarily expect an automatic follow-on loan when they pay off their existing loan. Therefore, a commercial bank may be able to stop new lending for a period without destroying its ability to collect its existing loans. The same is not true of most MFIs. Immediate follow-on loans are the norm for most microcredit. If an MFI stops issuing repeat loans for very long, customers lose their primary incentive to repay, which is their confidence that they will have timely access to future loans when they need them. When an MFI stops new lending, many of its existing borrowers will usually stop repaying. This makes the stop-lending order a weapon too powerful to use, at least if there is any hope of salvaging the MFI's portfolio.

**Asset Sales or Mergers.** A typical MFI's close relationship with its clients may mean that loan assets have little value in the hands of a different management team. Therefore, a supervisor's option of encouraging the transfer of loan assets to a stronger institution may not be as effective as in the case of collateralized commercial bank loans.

The fact that some key supervisory tools do not work very well for microfinance certainly does not mean that MFIs cannot be supervised. However, regulators should weigh this fact carefully when they decide how many new licenses to issue, and how conservative to be in setting capital-adequacy standards or required levels of past performance for transforming MFIs.

### **Costs of Supervision**

Promoters of new regulatory windows for MFIs are rightly enthusiastic about the possibility of bringing financial services to people who have never had access to them before. Supervisors, on the other hand, tend to concentrate more on the costs of supervising new, small entities. Good microfinance regulation needs to balance both factors.

In relation to the assets being supervised, specialized MFIs are much more expensive to supervise than full-service banks. One supervisory agency with several years of experience found that supervising MFIs cost it 2 percent per year of the assets of those institutions—about 30 times as expensive as its supervision of commercial bank assets. Donors who promote the development of depository microfinance should also consider providing a transitional subsidy for supervising the resulting institutions—particularly in the early stages when the supervisory staff is learning about microfinance and there are a small number of institutions to share the costs of supervision. However, in the long term, the government must decide whether it will subsidize these costs or make MFIs pass them on to their customers.

Even if a donor pays the additional cash costs of MFI supervision, there is a further cost in terms of the time and attention of the managers of the supervisory agency. In some developing and transitional economies, the national economy is at serious risk because of systemic problems with the country's commercial banks. In such settings, serious consideration should be given to the cost of diverting too much of the agency management's attention away from their primary task, by requiring them to spend time on small MFIs that pose no threat to the country's financial systems.

The administrative costs within the supervised MFI are also substantial. It would not be unusual for compliance to cost an MFI 5 percent of assets in the first one to two years and 1 percent or more thereafter.

### **Where to Locate Microfinance Supervision?**

Given the problem of budgeting scarce supervisory resources, alternatives to the conventional supervisory mechanisms used for commercial banks are frequently proposed for depository MFIs.

#### ***Within the Existing Supervisory Authority?***

The most appropriate supervisory body for depository microfinance is usually (though not always) the supervisory authority responsible for commercial banks. Using this agency to supervise microfinance takes advantage of existing skills and lowers the incentive

for regulatory arbitrage. The next question is whether to create a separate department of that agency. The answer will vary from country to country, but at a minimum, specially trained supervisory staff is needed, given the differing risk characteristics and supervisory techniques in the case of MFIs and microfinance portfolios.

The question whether to house microfinance regulation within the existing supervisory authority becomes more complicated when both non-depository microlending institutions and depository MFIs are to be addressed within a single, comprehensive regulatory scheme. The tasks involved in issuing permits to non-depository microlending institutions have relatively little to do with the prudential regulation and supervision of depository institutions. In some contexts, lodging both of these disparate functions within the same regulatory body might be justified on pragmatic grounds—such as the absence of any other appropriate body, or the likelihood that the permit-issuing function would be more susceptible to political manipulation and abuse if carried out by another body. In other cases, non-depository MFIs are required to report to the banking supervisor in order to make it easier for them to move eventually into more services and more demanding prudential regulation. Often, however, the risks of consolidating prudential and non-prudential regulation of microfinance within the supervisory body responsible for banks will outweigh the benefits. These risks include the possibility of confusion on the part of supervisors as to the appropriate treatment of non-depository institutions, and the possibility that the public will see the supervisory authority as vouching for the financial health of the non-depository institutions, even though it is not (and should not be) monitoring the health of these institutions closely.

### ***“Self-Regulation” and Supervision***

Sometimes regulators decide that it is not cost-effective for the government financial supervisor to provide direct oversight of large numbers of MFIs. Self-regulation is sometimes suggested as an alternative. Discussion of self-regulation tends to be confused because people use the term to mean different things. In the present discussion, “self-regulation” means regulation (and/or supervision) by any body that is effectively controlled by the regulated entities, and thus not effectively controlled by the government supervisor.

This is one point on which historical evidence seems clear. Self-regulation of financial intermediaries in developing countries has been tried many times, and has virtually never been effective in protecting the soundness of the regulated organizations. One cannot assert that effective self-regulation in these settings is impossible in principle, but it can be asserted that such self-regulation is almost always an unwise gamble, against very long odds, at least if it is important that the regulation and supervision actually enforce financial discipline and conservative risk management.

Sometimes regulators have required certain small intermediaries to be self-regulated, not because they expect the regulation and supervision to be effective, but because this is politically more palatable than saying that these deposit takers will be unsupervised. This can be a sensible accommodation in some settings. While self-regulation probably will not keep financial intermediaries healthy, it may have some benefits in getting institutions to begin a reporting process or in articulating basic standards of good practice.

### ***Delegated Supervision***

“Delegated supervision” refers to an arrangement in which the government financial supervisor delegates direct supervision to an outside body, while monitoring and controlling that body’s work. This seems to have worked, for a time at least, in some cases where the government financial supervisor closely monitored the quality of the delegated supervisor’s work, although it is not clear that this model reduces total supervision costs. Where this model is being considered, it is important to have clear answers to three questions. (1) Who will pay the substantial costs of the delegated supervision and the government supervisor’s oversight of it? (2) If the delegated supervisor proves unreliable and its delegated authority must be withdrawn, is there a realistic fallback option available to the government supervisor? (3) When a supervised institution fails, which body will have the authority and ability to clean up the situation by intervention, liquidation, or merger?

Because many MFIs are relatively small, there is a temptation to think that their supervision can be safely delegated to external audit firms. Unfortunately, experience has been that external audits of MFIs, even by internationally affiliated audit firms, very seldom in-

clude testing that is adequate to provide a reasonable assurance as to the soundness of the MFI's loan assets, which is by far the largest risk area for microlenders. If reliance is to be placed on auditors, the supervisor must require microfinance-specific audit protocols that are more effective, and more expensive, than the ones now in general use, and must regularly test the auditors' work.

### **Conclusion**

Discussion of microfinance regulation and supervision is necessarily complex and filled with qualifications and caveats. For the sake of clarity and emphasis, this paper concludes with a brief reiteration of some of its more important recommendations. Powerful new "microfinance" techniques are being developed that allow formal financial services to be delivered to low-income clients who have previously not had access to such services. In order to reach its full potential, the microfinance industry must eventually be able to enter the arena of licensed, prudentially supervised financial intermediation, and regulations must eventually be crafted that allow this development.

- Problems that do not require the government to oversee and attest to the financial soundness of regulated institutions should not be dealt with through prudential regulation. Relevant forms of non-prudential regulation, including regulation under the commercial or criminal codes, tend to be easier to enforce and less costly than prudential regulation.
- Proponents of microfinance regulation need to be careful about steps that might bring the topic of microcredit interest rates into public and political discussion. Microcredit needs high interest rates. In many countries, it may be impossible to get explicit political acceptance of a rate that is high enough to allow viable microfinance. In other contexts, concerted education of relevant policymakers may succeed in establishing the necessary political acceptance.
- Credit reference services can lower lenders' costs and expand the supply of credit for lower-income borrowers. However, they are

not technically feasible in all countries.

- A microlending institution should not receive a license to take deposits until it has demonstrated that it can manage its lending profitably enough so that it can cover all its costs, including the additional financial and administrative costs of mobilizing the deposits it proposes to capture.
- Before regulators decide on the timing and design of prudential regulation, they should obtain a competent financial and institutional analysis of the leading MFIs, at least if existing MFIs are the main candidates for a new licensing window being considered.
- Prudential regulation should not be imposed on “credit-only” MFIs that merely lend out their own capital, or whose only borrowing is from foreign commercial or noncommercial sources or from prudentially regulated local commercial banks.
- Depending on practical costs and benefits, prudential regulation may not be necessary for MFIs taking cash collateral (compulsory savings) only, especially if the MFI is not lending out these funds.
- As much as possible, prudential regulation should be focused on the type of transaction being conducted rather than the type of institution conducting it.
- Where possible, regulatory reform should include adjusting any regulations that would preclude existing financial institutions (banks, finance companies, etc.) from offering microfinance services, or that would make it unreasonably difficult for such institutions to lend to MFIs.
- Where cost-effective prudential supervision is impractical, consideration should be given to allowing very small community-based intermediaries to continue taking deposits from members without being prudentially supervised, especially in cases where most members do not have access to safer deposit vehicles.
- Minimum capital needs to be set high enough so that the supervisory authority is not overwhelmed by more new institutions than it can supervise effectively.
- Most microlending is for all practical purposes unsecured. Limits on unsecured lending, or high provisioning of unsecured portfolio



that has not fallen delinquent, are not practical for MFIs. Instead, risk control needs to be based on the MFI's historical collection performance, and analysis of its lending systems and practices.

- Loan documentation and reporting requirements need to be simpler for microfinance institutions and operations than for normal commercial bank operations.
- Limitations on foreign ownership or maximum shareholder percentages may be inappropriate, or need flexible application, if local microfinance is at a stage where much of the investment will have to come from transforming NGOs and other socially motivated investors.
- Designers of new regulation for microfinance need to pay much more attention to issues of likely effectiveness and cost of supervision than is usually done. Financial intermediation licenses are promises. Before issuing them, a government needs to be clear about the nature of the promises and its practical ability to honor them.
- Design of microfinance regulation should not proceed very far without estimating supervision costs realistically and identifying a sustainable mechanism to pay for them. Donors who encourage governments to take on supervision of new types of institution should be willing to help finance the start-up costs of such supervision.
- Supervision of microfinance—especially portfolio testing—requires some techniques and skills that are different from those used to supervise commercial banks. Supervisory staff will need to be trained and to some extent specialized in order to deal effectively with MFIs.
- Financial cooperatives—at least large ones—should be prudentially supervised by a specialized financial authority, rather than by an agency that is responsible for all cooperatives.
- In developing countries, “self-supervision” by an entity under the control of those supervised is extremely unlikely to be effective in protecting the soundness of the supervised financial institutions.
- External auditors cannot reliably appraise the financial condition

of MFIs unless they test portfolio with microfinance-specific procedures that go well beyond normal present practice.

## Notes

The text of this chapter was first published by the World Bank Group in July 2003 as *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance*.

<sup>1</sup> Average microcredit loan balances tend to be below per capita national income.

<sup>2</sup> This chapter does not address insurance and leasing, even though these financial services have important potential for lower-income people. For these services, there is almost no experience yet with specialized regulation focused on the needs of poorer clients.

<sup>3</sup> The term “non-prudential regulation” poses some problems. The distinction between prudential and non-prudential regulation is not always clear—sometimes a rule serves both prudential and non-prudential objectives. For example, regulation aimed at prevention of financial crimes (*see infra* the discussion on fraud and financial crimes) also contributes to prudential objectives. Moreover, defining non-prudential regulation simply by reference to what it is not leaves open the question of the scope of the concept. The term “conduct of business” regulation is sometimes used to denote the non-prudential rules applicable to financial institutions. However, this term is also problematic since prudential regulation also affects the conduct of a financial institution’s business.

<sup>4</sup> This is not to say, of course, that the failure of a lending-only MFI has no adverse consequences. If customers lose access to loans from an MFI, it may become a severe problem particularly if the failing microlender is the only available source of much-needed capital. However, the same is true of any other important supplier. The fact that a good or service is important to customers has not been held to justify prudential regulation of the supplier’s business.

<sup>5</sup> *See, e.g.*, the treatment of permission to lend later in the discussion.

<sup>6</sup> *See, e.g.*, the treatment of interest rate limitations later in the discussion.

<sup>7</sup> *See* the treatment of fraud and financial crime prevention later in the discussion.

<sup>8</sup> The point here is not that cost of funds and loan losses is always the same for MFIs and commercial banks, but rather that both types of lenders face higher administrative costs per dollar lent when they engage in microlending.

<sup>9</sup> Sometimes, of course, high interest rates do reflect inefficiency (excessive administrative costs) on the part of MFIs. However, competition has been proven to address this problem better than interest rate caps.

<sup>10</sup> In the case of prudentially regulated financial institutions, these types of restrictions are sometimes exacerbated by other, prudentially motivated, limitations on ownership. (*See infra* the discussion of ownership suitability and diversification requirements.)

<sup>11</sup> The discussion of MFI transformation in this section has dealt with non-prudential issues only. Such transfers are also affected by prudential rules, especially the rules about suitability and diversification of owners, discussed later in this chapter.

<sup>12</sup> A useful analysis of microfinance regulation along these lines can be found in Hennie van Greuning, Joselito Gallardo, and Bikki Randhawa, “A Framework for Regulating Microfinance Institutions,” Policy Research Working Paper 206 (Washington: World Bank, 1999).

<sup>13</sup> In some countries, banks have to provision 100 percent of unsecured loans, except for loans to other licensed intermediaries. In such a context, banks may be more willing to lend to MFIs who are themselves licensed, and thus licensed MFIs might be able to borrow at a low interbank rate. These are reasons why an MFI borrowing from commercial banks might want to be prudentially licensed, but they do not justify imposition of a licensing requirement.

<sup>14</sup> Rationing licenses is not cost-free, because barriers to entry hinder competition.

<sup>15</sup> Regulators sometimes hope that, instead of shutting down, these small intermediaries will merge to form larger ones that can be supervised more easily. But the practical economies of branch operations can often make this impossible.

<sup>16</sup> Capital adequacy has to do with maintaining a prudent relationship between an institutions’ risk assets and its “cushion” of owner’s funds. This relationship is affected, not only by the equity/assets ratio, but also by the rules for risk-weighting and provisioning. Capital adequacy in the broad sense is managed using a combination of these measures.

<sup>17</sup> This section discusses prudentially driven ownership requirements. These tend to overlap with non-prudential ownership requirements discussed earlier.

<sup>18</sup> This statement does not imply that prudential regulation will eventually embrace all institutions providing microfinance services.

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MICHAEL GRUSON

**The Purpose of Supplementary Supervision**

On November 20, 2002, the European Parliament adopted Directive 2002/87/EC<sup>1</sup> introducing supplementary supervision of financial conglomerates (hereinafter the Supplementary Supervision Directive).

The principal reason for this Directive was the need to face the accelerating pace of consolidation in the financial industry and the intensification of links between financial markets. Over the past years, a number of cross-sector groups combining insurance companies, banks, and investment firms have been created and have become of significant importance in the European Union (EU).<sup>2</sup> Combined financial operations may create new prudential risks or exacerbate existing ones.<sup>3</sup> Laws and regulations dealing with different financial sectors were not able to deal with these developments and such laws have traditionally adopted different approaches with different definitions of capital, different types of risks, and different capital requirements.<sup>4</sup> For instance, insurance supervisors have historically been primarily concerned with the liability side of the balance sheet as the main source of risk, although assets are of course monitored too. Regulations in the banking sector regard the asset side of the balance sheet as the principal source of risk, although an examination of the source of funding is an important aspect of the supervisory process. Securities supervisors require securities firms to have sufficient liquid assets to repay promptly all liabilities at any time. The scope for potential supervisory problems increases if a financial conglomerate spans a number of financial markets due to the web of financial interrelationships characteristic of financial conglomerates. On the other hand, such conglomerates may gain financial solidity by diversifying that risk.<sup>5</sup> The Supplementary Supervision Directive intends to ensure

the stability of the European financial market, establish common prudential standards for the supervision of such financial groups throughout Europe, and introduce level playing fields and legal certainty between financial institutions.<sup>6</sup>

### **Relationship to Existing Solo and Consolidated Supervision**

The basic philosophy of the Supplementary Supervision Directive is that the solo supervisions of individually regulated entities should continue to be the foundation for effective supervision. Furthermore, the Supplementary Supervision Directive does not replace the existing consolidated or supplementary supervision of groups that operate in one sector of the financial industry, but introduces an additional *supplementary* supervision of the regulated entities in groups that straddle more than one financial sector. The Supplementary Supervision Directive is based on the notion that the various supervisory authorities of different sectors of the financial industry and the supervisory authorities of the different member states need to establish a coordinated approach in order that prudential assessment can be made from a group-wide perspective.<sup>7</sup>

In addition to solo supervision, consolidated supervision applies on a sectoral basis to groups of credit institutions, investment firms, and financial institutions.<sup>8</sup> The Banking Directive<sup>9</sup> requires consolidated supervision of (1) every credit institution<sup>10</sup> that has another credit institution or a financial institution<sup>11</sup> as a subsidiary<sup>12</sup> or that holds a participation<sup>13</sup> in such institution, and (2) every credit institution whose parent is a financial holding company.<sup>14</sup> The Capital Adequacy Directive expands consolidated supervision to groups including investment firms.<sup>15</sup> Consolidated supervision applies to (1) every investment firm that has a credit institution, an investment firm, or another financial institution as a subsidiary or that holds a participation in such entity and (2) every investment firm whose parent is a financial holding company.<sup>16</sup> Investment firms are in effect brokers, dealers, investment managers having discretion, and underwriters.<sup>17</sup> Only credit institutions, investment firms, and financial holding companies can head a group subject to consolidated supervision. Thus, consolidated supervision is not required for credit institutions or investment firms that are subsidiaries of companies that are neither credit institutions, investment firms, nor financial holding companies. Financial institutions (other than investment firms) are part of a group subject to

consolidated supervision only if they are subsidiaries of credit institutions, investment firms, or financial holding companies; they are not part of a group subject to consolidated supervision if they are subsidiaries of other financial institutions that are neither investment firms nor financial holding companies.

Supervision on a consolidated basis of groups that include credit institutions means supervision on the basis of the consolidated financial situation in the following areas:<sup>18</sup> consolidated calculation of own funds, consolidated computation of the solvency ratio, consolidated control of adequacy of own funds to cover market risks, consolidated control of large exposures, and consolidated restriction on investments in the nonbank sector. Supervision on a consolidated basis of groups that include investment firms (but not credit institutions) means supervision on the basis of the consolidated financial situation in the areas mentioned above, except that it does not apply to the restriction on investments in the nonbank sector.<sup>19</sup>

The Banking Directive hesitates to regulate directly non-EU entities. For this reason, application of the principle of supervision on a consolidated basis to credit institutions whose parents have their head offices in non-EU countries and to credit institutions situated in non-EU countries whose parents (credit institutions or financial holding companies) have their head offices in a member state shall be made possible by virtue of reciprocal bilateral agreements to be entered into between the competent authorities of the member states and the non-EU countries concerned.<sup>20</sup>

The Supplementary Supervision Directive, however, amended the Banking Directive to deal with the situation of an EU-authorized credit institution or investment firm that is a subsidiary of a non-EU credit institution or financial institution but is not subject to consolidated supervision—presumably because no agreement was entered into with the non-EU country of the parent. If an EU-authorized credit institution is a subsidiary of a non-EU credit institution or financial institution, the competent authority shall verify whether the EU-authorized credit institution is subject to consolidated supervision by the home country of the non-EU parent that is equivalent to that governed by the principles laid down in Art. 52, Banking Directive.<sup>21</sup> In the absence of such equivalent supervision, member states shall apply the provisions of Art. 52, Banking Directive to the credit institution



by analogy. As an alternative, member states shall allow their competent authorities to apply other appropriate supervisory techniques that achieve the objectives of the supervision on a consolidated basis.<sup>22</sup> The competent authorities, which would be responsible for consolidated supervision, must agree on those methods; they may, in particular, require the establishment of a financial holding company that has its head office in the European Union and apply the provision on consolidated supervision to the consolidated position of that financial holding company.<sup>23</sup>

Insurance groups are subject to a more limited supplementary supervision under the Insurance Group Directive.<sup>24</sup> Supplementary supervision applies to any EU-authorized life or non-life insurance undertaking<sup>25</sup> that has at least one subsidiary<sup>26</sup> that is an EU-authorized life or non-life insurance undertaking, reinsurance undertaking,<sup>27</sup> or non-EU insurance undertaking,<sup>28</sup> or holds a participation<sup>29</sup> in any such entity or is linked by a horizontal structure with any such entity.<sup>30</sup> Supplementary supervision also applies to every EU-authorized life or non-life insurance undertaking the parent<sup>31</sup> of which is an insurance holding company,<sup>32</sup> a reinsurance undertaking, or a non-EU insurance undertaking.<sup>33</sup> Lastly, supplementary supervision applies to every EU-authorized life or non-life insurance undertaking the parent of which is a mixed-activity insurance holding company.<sup>34</sup> The supplementary supervision of all insurance groups relates to intra-group transactions,<sup>35</sup> the computation of an adjusted or analogous solvency calculation,<sup>36</sup> adequate internal control mechanisms for the production of any data and information relevant for the purposes of such supplementary supervision,<sup>37</sup> and the sufficiently good repute and sufficient experience of the management of an insurance holding company.<sup>38</sup>

## **Determination of Financial Conglomerates and the Addressees of Supplementary Supervision**

### **Sectoral and Cross-Sectoral Supervision**

The EU legal framework for the supervision of financial institutions before the adoption of the Supplementary Supervision Directive was incomplete because it only covered the so-called sectoral supervision; that is, supervision over institutions within a particular sector

of the financial industry. Except in the case of credit institutions and investment firms, cross-sectoral supervision of financial groups (combining institutions from different financial sectors) existed only to a very limited extent.<sup>39</sup> The Supplementary Supervision Directive changes this situation by, generally speaking, introducing supplementary supervision of regulated entities in financial conglomerates that straddle several financial sectors. Since cross-sectoral supervision of groups including credit institutions and investment firms already existed, the Supplementary Supervision Directive in effect adds insurance companies to the system of cross-sectoral supervision.

Table 1 sets forth the entities that are part of the financial sectors.

**Table 1. Financial Sector Entities**

	<b>Banking Sector</b>	<b>Investment Sector</b>	<b>Insurance Sector</b>	<b>Mixed Financial Holding Company</b>
<b>Regulated Entities</b>	Credit institution Asset management company	Investment firm Asset management company	Life insurance undertaking Non-life insurance undertaking Asset management company	
<b>Nonregulated Entities</b>	Financial institution (other than an investment firm) Ancillary banking service undertaking	Financial institution (other than an investment firm)	Reinsurance undertaking Insurance holding company	Mixed financial holding company

A regulated entity is defined as a credit institution, an insurance undertaking, or an investment firm.<sup>40</sup> The definition of “regulated entity” itself does not require that the regulated entity be located in the

European Union and therefore also includes non-EU entities that would have to be authorized under one of the sectoral Directives if they were located in the European Union. However, only regulated entities that have obtained an authorization pursuant to one of the sectoral Directives<sup>41</sup> are subject to supplementary supervision within the meaning of the Supplementary Supervision Directive.<sup>42</sup> Such an authorization is only required for undertakings that are located in the European Union.<sup>43</sup> Thus, supplementary supervision only applies to regulated entities that are established and authorized in the European Union, except that EU-regulated entities with a parent outside the European Union are not subject to supplementary supervision. As further discussed below under the section dealing with equivalent supervision for parent undertakings outside the European Union, if the parent of an EU-regulated entity has its head office in a country outside the European Union, the Supplementary Supervision Directive yields in favor of the supervision by the home country of the parent if that supervision is equivalent to the supervision under the Supplementary Supervision Directive. The EU-regulated entities are subject to analogous or appropriate supplementary supervision under the Supplementary Supervision Directive only if the parent's home country does not have an equivalent supervision.

### **Financial Conglomerates**

The Supplementary Supervision Directive applies to certain EU-regulated entities (credit institutions, insurance undertakings, and investment firms) that have obtained an authorization pursuant to one of the sectoral Directives.<sup>44</sup> If such entities are part of a financial conglomerate, they may be subject to supplementary prudential supervision.<sup>45</sup> In order to determine whether a regulated entity is subject to supplementary supervision, three inquiries must be made: first, whether the regulated entity is part of a group; second, whether the group meets the requirements of a financial conglomerate; and third, whether the regulated entity is one that is the addressee of supplementary supervision.

#### ***Definition of Group***

A “group” is determined (1) by a parent-subsidiary relationship,<sup>46</sup> (2) by a relationship based on a participation,<sup>47</sup> or (3) by a horizontal structure.<sup>48</sup>

Whereas, generally speaking, a “subsidiary” is an undertaking in which a shareholder (the parent) has a majority of the voting rights or the right to exercise a controlling influence, and a “participation” is an equity investment of 20 percent or more, a “horizontal structure” exists without an equity relationship if undertakings are managed on a unified basis pursuant to a contract or charter provision or if the administration, management, or supervisory bodies of both undertakings consist for the major part of the same persons. A horizontal structure is a case of control without equity investment.

A U.S. observer would say that a “group” in the meaning of the Supplementary Supervision Directive is determined by concepts very similar to the U.S. Bank Holding Company Act’s concept of control, which determines whether a parent-subsidiary relationship exists.<sup>49</sup>

### ***Definition of Financial Conglomerate***

A group constitutes a financial conglomerate if it meets certain conditions. For purposes of determining a financial conglomerate, the Supplementary Supervision Directive distinguishes between groups that are headed by an EU-regulated entity and groups that are not headed by an EU-regulated entity (in the case of the latter, the group would be headed either by a non-EU-regulated entity or by a non-regulated entity).

In both cases (financial conglomerate headed by an EU-regulated entity and financial conglomerate not so headed), the activities of the entities in the insurance sector and the activities of the entities in the banking and investment services sector (taken together) must be significant (i.e., based on ratios of balance sheets and solvency ratio requirements, each financial sector must represent at least 10 percent of the group or the balance sheets of the smallest sector in the group must exceed €6 billion).<sup>50</sup>

A group that is not headed by an EU-regulated entity only qualifies as a financial conglomerate if the group’s activities mainly occur in the financial sector (that is, based on the balance sheets, the financial sector entities must represent at least 40 percent of the group). On the other hand, a group that is headed by an EU-regulated entity

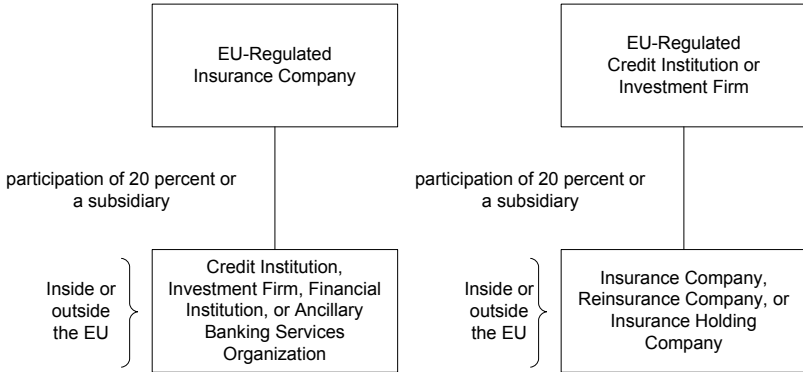
qualifies as a financial conglomerate even though its activities do not mainly occur in the financial sector.<sup>51</sup>

The Supplementary Supervision Directive introduces and defines the term “mixed financial holding company” to cover financial conglomerates headed by a nonregulated entity holding company. In fact, every nonregulated entity head of a financial conglomerate by definition is a mixed financial holding company.<sup>52</sup> The Supplementary Supervision Directive could have called such entities “nonregulated entity holding companies.” The mixed financial holding company could be a nonregulated financial sector entity, such as a financial institution other than an investment firm (a mere holding company without its own activities would likely be a financial institution) or a reinsurance undertaking, or it could be a commercial or industrial company. The definitions of “financial conglomerate” and “mixed financial holding company” do not require that the head of the financial conglomerate or the mixed financial holding company must be established or have its head office in the European Union. However, if a financial conglomerate headed by a mixed financial holding company is to be covered by supplementary supervision, the mixed financial holding company must be located in the European Union.<sup>53</sup> In the same way, if the financial conglomerate is headed by a regulated entity, it is subject to supplementary supervision only if the regulated entity is an EU-regulated entity.<sup>54</sup> A financial conglomerate headed by a non-EU-regulated entity and a financial conglomerate headed by a mixed financial holding company having its head office outside the European Union are still financial conglomerates, but the regulated entities in those financial conglomerates are not subject to supplementary supervision; as discussed below under the section dealing with equivalent supervision for parent undertakings outside the EU, they may, however, be subject to equivalent supplementary supervision by the home country of the non-EU-regulated entity or the mixed financial holding company or to analogous or appropriate supplementary supervision by a member state under the Supplementary Supervision Directive.<sup>55</sup> Figure 1 sets forth the entities that are part of a financial conglomerate.

## Figure 1. Financial Conglomerates

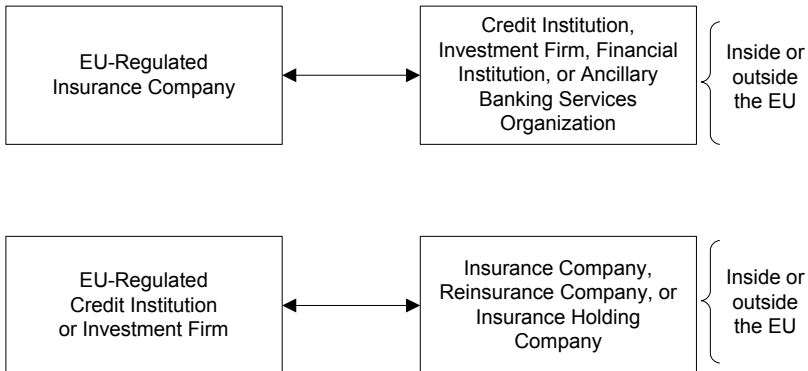
### Financial Conglomerates Subject to Supplementary Supervision

#### (a) Group Headed by an EU-Regulated Entity



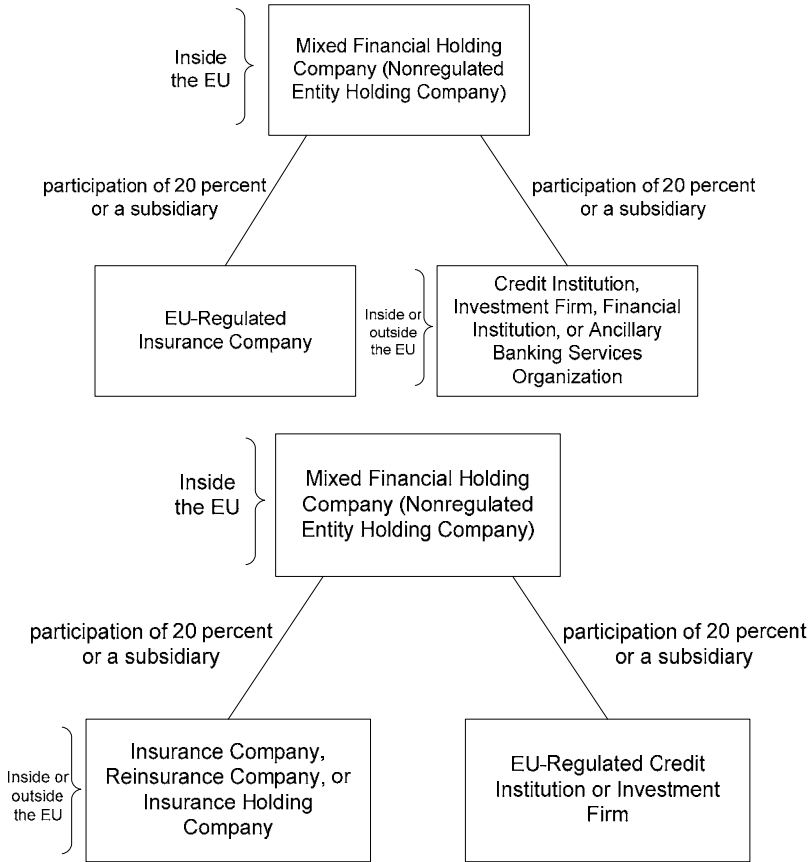
- *Banking plus investment services sector and insurance sector must each be significant (10 percent or at least €6 billion test).*

#### (b) Horizontal Financial Conglomerate



- *Banking plus investment services sector and insurance sector must each be significant (10 percent or at least €6 billion test).*
- *Group must be mainly engaged in the financial sector (40 percent of group test).*

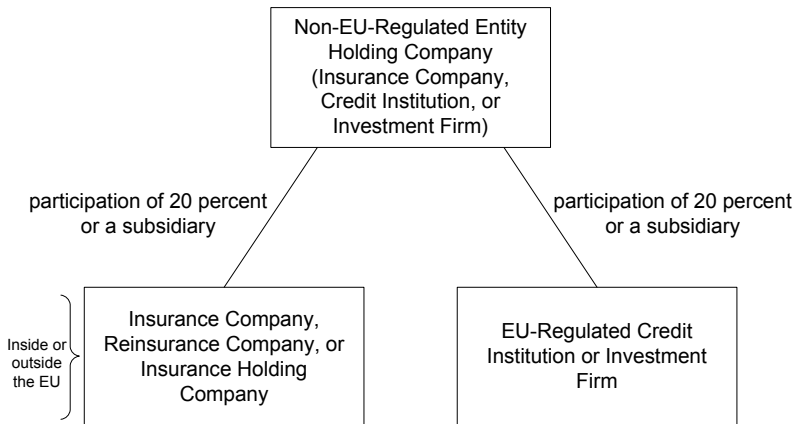
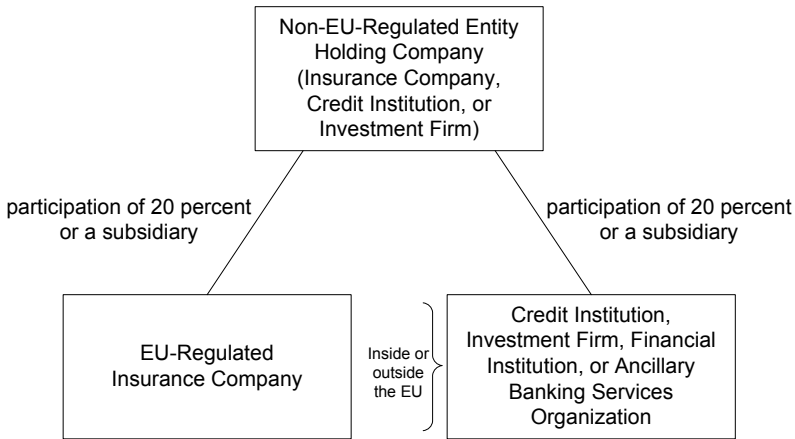
**(c) Group Headed by a Mixed Financial Holding Company with EU Head Office**



- *Banking plus investment services sector and insurance sector must each be significant (10 percent or at least €6 billion test).*
- *Group must be mainly engaged in the financial sector (40 percent of group test).*

**Financial Conglomerates Subject to Equivalent, Analogous, or Appropriate Supplementary Supervision**

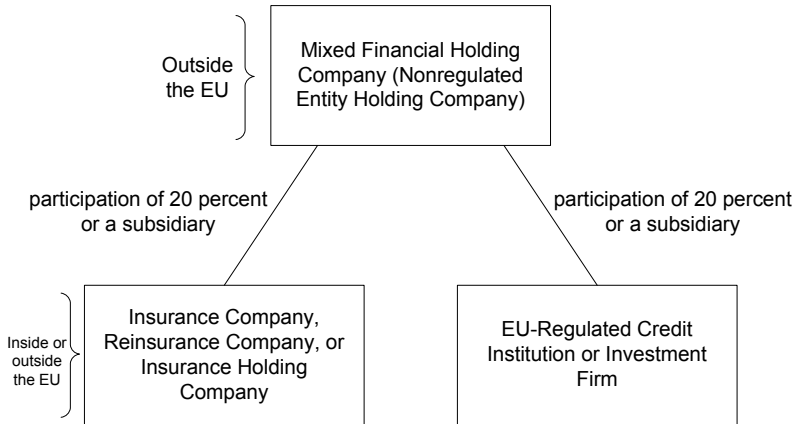
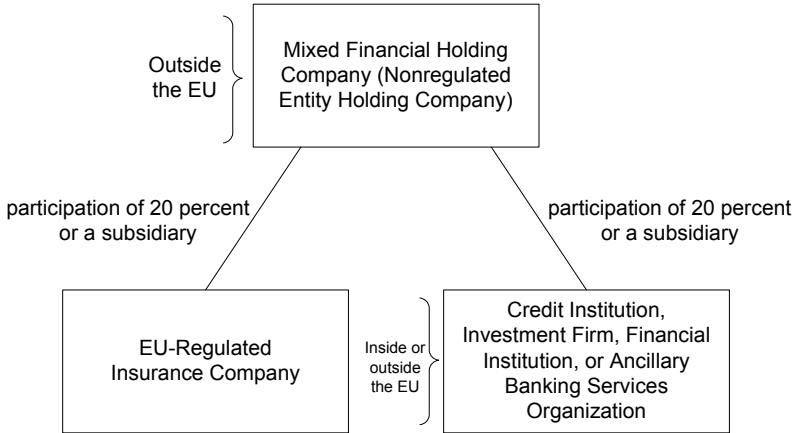
**(d) Group Headed by a Non-EU-Regulated Entity**



- *Banking plus investment services sector and insurance sector must each be significant (10 percent or at least €6 billion test).*
- *Group must be mainly engaged in the financial sector (40 percent of group test).*



**(e) Group Headed by Mixed Financial Holding Company with Non-EU Head Office**



- *Banking plus investment services sector and insurance sector must each be significant (10 percent or at least €6 billion test).*
- *Group must be mainly engaged in the financial sector (40 percent of group test).*

From the U.S. perspective, it is surprising that conglomerates that are headed by a mixed financial holding company are subject to supplementary supervision only if the group is mainly engaged in the financial sector, that is, banking, insurance, or investment services, and that in all financial conglomerates the banking sector and the insurance sector must be significant. If it is the purpose of the Supplementary Supervision Directive to protect regulated entities, the relative size of such regulated entities should not be a relevant factor. However, the Supplementary Supervision Directive goes further than the rules on consolidated supervision. The rules on consolidated supervision require consolidated supervision for credit institutions in which another credit institution holds a participation or that are subsidiaries of another credit institution or of a financial holding company, that is, a company the subsidiaries of which are exclusively or mainly credit institutions or financial institutions and that has at least one credit institution subsidiary.<sup>56</sup> Consolidated supervision does not extend to a group headed by a mixed-activity holding company, which is defined as a parent other than a financial holding company, a credit institution, or a mixed financial holding company, whose subsidiaries include at least one credit institution.<sup>57</sup> Thus, neither the proverbial steel company that acquires a bank nor the acquired bank is subject to consolidated supervision under EU law because the steel company is not a financial holding company.

However, if the steel company is located in the European Union and acquires a bank and an insurance company, and their combined balance sheet total of both amounts to 40 percent of the balance sheet total of the group, the steel company would be a mixed financial holding company heading a financial conglomerate and the financial conglomerate would be subject to supplementary supervision under the Supplementary Supervision Directive. A holding company without its own business activities whose principal activity consists of acquiring holdings in industrial and financial companies is a financial institution<sup>58</sup> and if the subsidiaries of such financial institution mainly consist of credit institutions or financial institutions, it is a financial holding company<sup>59</sup> and the group headed by it is subject to consolidated supervision.<sup>60</sup> If the subsidiaries do not mainly consist of credit or financial institutions, it is not a financial holding company subject to consolidated supervision. If the above holding company holds a credit institution and an insurance company, one of which is a subsidiary, and both of which are significant and if the group's activities

mainly (based on the 40 percent test) consist of financial sector activities, it is a mixed financial holding company that heads a financial conglomerate subject to supplementary supervision. If its activities do not consist mainly of financial sector activities, it is subject neither to consolidated nor to supplementary supervision.<sup>61</sup>

### ***Discretionary Expansion of Financial Conglomerate***

The Supplementary Supervision Directive gives the competent authorities discretion to apply supplementary supervision to groups that do not meet the definition of financial conglomerate or even the definition of group and to carry out supplementary supervision “as if they constitute a financial conglomerate.”<sup>62</sup>

The competent authorities may exercise supplementary supervision over regulated entities that are controlled by another entity or in which another entity has a capital investment, even though the relationship does not qualify as a group or as a financial conglomerate. Regulated entities in such quasi-financial conglomerates are, in the discretion of the relevant competent authorities, subject to supplementary supervision if (1) at least one of the regulated entities is an EU-regulated entity, (2) at least one of the entities in the quasi-financial conglomerate is within the insurance sector and at least one is within the banking or investment services sector, and (3) the consolidated and/or aggregated activities of the entities in the quasi-financial conglomerate within the insurance sector and the consolidated and/or aggregated activities of the entities within the banking and investment services sector are each significant.<sup>63</sup>

### ***Determination of Financial Conglomerate***

The Supplementary Supervision Directive does not impose on financial conglomerates a duty to report to or file with any supervisory authority the fact that they are financial conglomerates. The competent authorities themselves must make that determination. If a competent authority is of the opinion that a regulated entity authorized by it is a member of a group that may be a financial conglomerate, which has not already been identified according to the Supplementary Supervision Directive, the competent authority shall communicate its view to the other competent authorities concerned. The coordinator, as discussed below, shall inform the parent of the group (or in the ab-

sence of a parent, the regulated entity with the largest balance sheet held in the most important financial sector in the group) that the group has been identified as a financial conglomerate and of the appointment of the coordinator.<sup>64</sup> The coordinator shall also inform the competent authorities that have authorized regulated entities in the group and the competent authorities of the member states in which the mixed financial holding company has its head office, as well as the EU Commission.<sup>65</sup>

The high degree of discretion given to the member states and their supervisory authorities in determining whether a group or a financial conglomerate exists could lead to substantial differences among the member states in the determination of whether supplementary supervision applies. This would not only create legal uncertainties but could also cause competitive distortions.

### **Undertakings in a Financial Conglomerate That Are the Addressees of Supplementary Supervision**

The Supplementary Supervision Directive does not envision that all companies in a financial conglomerate be subject to supplementary supervision, and the scope of supplementary supervision differs among certain categories of companies in a financial conglomerate. The Supplementary Supervision Directive distinguishes between entities that are the addressees of supplementary supervision, entities that are subject to certain obligations under the Supplementary Supervision Directive, and entities that are only indirectly affected by the Supplementary Supervision Directive.

The Supplementary Supervision Directive refers to entities that are the addressees of the supplementary supervision as entities that are “subject to supplementary supervision at the level of the financial conglomerate.”<sup>66</sup> Only certain EU-regulated entities (hereinafter the Responsible Entities) are “subject to supplementary supervision at the level of the financial conglomerate”:

- every EU-regulated entity that is at the head of a financial conglomerate;

- every EU-regulated entity whose parent undertaking is a mixed financial holding company having its head office in the European Union; and
- every EU-regulated entity linked with another financial sector entity by a relationship of a horizontal group, that is, every EU-regulated entity in a horizontal financial conglomerate.

These Responsible Entities must verify compliance with the requirements of supplementary supervision and are responsible for compliance by the financial conglomerate. In particular, the Responsible Entities must submit reports to the coordinator.<sup>67</sup> If a financial conglomerate is headed by an EU-regulated entity, only that entity (and not the other regulated entities in the financial conglomerate) must meet the requirements that must be met “at the level of the financial conglomerate.” In this case, supervision “on the level of the financial conglomerate” means supervision on the holding company level. On the other hand, if a financial conglomerate is headed by a mixed financial holding company having its head office in the European Union, each EU-regulated entity in the financial conglomerate must meet the requirements that must be met “at the level of the financial conglomerate.”<sup>68</sup>

The Supplementary Supervision Directive imposes certain obligations on all regulated entities in a financial conglomerate in order to make supplementary supervision at the level of the financial conglomerate possible.<sup>69</sup> However, to the extent the regulated entities are non-EU-regulated entities, the supplementary supervision at the level of the financial conglomerate does not imply that the competent authorities play a supervisory role with respect to such non-EU-regulated entities.<sup>70</sup> Furthermore, the Supplementary Supervision Directive assigns duties and obligations in connection with supplementary supervision at the level of the financial conglomerate to mixed financial holding companies.<sup>71</sup> Again, this does not imply that the competent authorities play a supervisory role with respect to mixed financial holding companies.<sup>72</sup>

Finally, supplementary supervision of a financial conglomerate will indirectly affect all entities in a financial conglomerate, including non-EU-regulated entities, nonregulated entities, and the mixed financial holding company in the financial conglomerate. For instance,

“intra-group transactions”<sup>73</sup> and “risk concentrations”<sup>74</sup> are defined to include relations between regulated entities (EU-regulated or non-EU-regulated) in a financial conglomerate and other entities or undertakings in the financial conglomerate. For purposes of calculating the capital adequacy requirements of a financial conglomerate, mixed financial holding companies, non-EU-regulated entities, and even nonregulated financial sector entities are included.<sup>75</sup> This does not imply that the competent authorities play a supervisory role with respect to those unregulated entities.<sup>76</sup>

Not all EU-regulated entities in a financial conglomerate are subject to supplementary supervision. EU-regulated entities that are members of a financial conglomerate headed by an EU-regulated entity<sup>77</sup> are not addressees of supplementary supervision, although they are included in the supplementary supervision of the EU-regulated entity head of the financial conglomerate. EU-regulated entities that are members of a financial conglomerate headed by a mixed financial holding company are subject to supplemental supervision only if the mixed financial holding company has its head office in the European Union.<sup>78</sup>

EU-regulated entities in a financial conglomerate headed by a non-EU-regulated entity or by a mixed financial holding company that has its head office outside the European Union are not at all subject to supplementary supervision.<sup>79</sup> If the parent undertaking of an EU-regulated entity is a regulated entity having its head office outside the European Union or is a mixed financial holding company having its head office outside the European Union, the EU-regulated entity, as discussed below under the section dealing with equivalent supervision for parent undertakings outside the EU, is either subject to equivalent supervision by the home country of the parent or subject to analogous or appropriate supplementary supervision by a member state pursuant to Art. 18, Supplementary Supervision Directive.<sup>80</sup>

Where a financial conglomerate is a subgroup of another financial conglomerate (the main financial conglomerate), member states may apply the provisions of the Supplementary Supervision Directive relating to supplementary supervision<sup>81</sup> only to regulated entities within the main financial conglomerate and not to the subgroup.<sup>82</sup> The nonfinancial activities of a nonregulated entity heading a group could have the effect that the group does not meet the financial

conglomerate tests.<sup>83</sup> In that case, one has to determine whether the nonqualifying group comprises subgroups that qualify as financial conglomerates.<sup>84</sup>

In order to avoid possible moral hazards,<sup>85</sup> the Supplementary Supervision Directive emphasizes that the exercise of supplementary supervision at the level of the financial conglomerate shall not imply that the competent authorities are required to play a supervisory role in relation to mixed financial holding companies, unregulated entities, or non-EU-regulated entities in a financial conglomerate, on a stand-alone basis, even though such entities are affected by the supplementary supervision.<sup>86</sup> However, certain entities in a financial conglomerate that are not EU-regulated entities are subject to supervision in their relations with the EU-regulated entities—for instance, in the computation of capital adequacy at the level of the financial conglomerate or in the evaluation of intra-group transactions.

The Supplementary Supervision Directive requires the inclusion of asset management companies in the sectoral and supplementary supervision. The Supplementary Supervision Directive provides that member states shall include asset management companies in the scope of consolidated supervision of credit institutions and investment firms, and/or in the scope of supplementary supervision of insurance undertakings in an insurance group, and—where the group is a financial conglomerate—in the scope of supplementary supervision within the meaning of the Supplementary Supervision Directive.<sup>87</sup> Asset management companies that are part of a financial conglomerate must be regarded as regulated entities.<sup>88</sup>

### **Supplementary Supervision**

The Supplementary Supervision Directive introduces a series of rules with regard to the supplementary supervision of regulated entities in a financial conglomerate. They relate in particular to capital adequacy, intra-group transactions, and risk concentration, and to the management. The Supplementary Supervision Directive also requires that for each financial conglomerate a single coordinator be appointed from among the competent authorities of the member states concerned who shall be responsible for coordination and exercise of supplemen-

tary supervision.<sup>89</sup> The competent authorities are also required to cooperate and exchange information.<sup>90</sup>

It must be emphasized that supplementary supervision does not mean supervision on a consolidated basis like the supervision provided by some of the sectoral rules. The Supplementary Supervision Directive follows a so-called “solo-plus” approach to supervision. The basis of supervision is the supervision of individual group entities on a solo basis by their respective sectoral regulators. The solo supervision of individual entities is complemented by a general quantitative assessment of the group as a whole and by a quantitative group-wide assessment of the adequacy of capital.<sup>91</sup> The Supplementary Supervision Directive does not require any additional consolidation of the accounts of the financial conglomerate as a whole if existing Directives do not impose such consolidation.

### **Capital Adequacy**

One of the most important issues regarding the supervision of financial conglomerates is the supervision of the group’s financial condition. Therefore, Article 6 and Annex I of the Supplementary Supervision Directive require the competent authorities to exercise supplementary supervision of the capital adequacy of the regulated entities in a financial conglomerate.<sup>92</sup> Eliminating any inappropriate intra-group creation of own funds,<sup>93</sup> such as double or multiple gearing,<sup>94</sup> or excessive leveraging is the major goal of such supplementary group-wide capital adequacy requirements.<sup>95</sup> In such situations, the same own funds are used simultaneously as a buffer more than once—to cover the capital requirements of the parent company, as well as those of a subsidiary (and possibly also those of a subsidiary of a subsidiary).<sup>96</sup> Thus, the member states must require regulated entities in a financial conglomerate to ensure that there are own funds at the level of the financial conglomerate that are always at least equal to the capital adequacy requirements as calculated in accordance with Annex I.<sup>97</sup> That means that all Responsible Entities in a financial conglomerate must see to it that at the level of the financial conglomerate, the capital adequacy requirements calculated in accordance with Annex I are met. In addition to the regulated entities in a financial conglomerate, certain specifically mentioned nonregulated financial sector entities in the financial conglomerate that may not be subject to capital adequacy requirements on a stand-alone basis must nonethe-



less be included for the purpose of calculating capital adequacy at the level of the financial conglomerate.<sup>98</sup> The solvency requirements for nonregulated financial sector entities that are not included in the sectoral solvency requirement computation are computed on a notional basis.<sup>99</sup>

The solvency requirements for each separate financial sector represented in a financial conglomerate continue to be covered by own funds elements in accordance with the corresponding sectoral rules.<sup>100</sup> In case of a deficit of own funds at the financial conglomerate level, only own funds elements that are eligible according to each of the sectoral rules (cross-sector capital) shall qualify for the verification of the compliance with the solvency requirements at the financial conglomerate level.<sup>101</sup>

### *Methods for Calculating the Solvency Position*

Annex I sets forth three different methods for calculating the solvency position on the level of a financial conglomerate. The competent authorities or the coordinator have the authority to choose which method shall be applied to a financial conglomerate<sup>102</sup> and they may also apply a combination of the three methods.<sup>103</sup> These methods are (1) accounting consolidation, (2) deduction and aggregation, and (3) requirement deduction.

**Method 1.** Accounting consolidation uses the consolidated accounts as a basis for calculating the supplementary capital adequacy. Thus, it is only applicable for consolidated groups. According to this method, the supplementary capital adequacy shall be calculated as the difference between (i) the own funds of the financial conglomerate calculated on the basis of the consolidated position of the group, and (ii) the sum of the solvency requirements for each different financial sector represented in the group.<sup>104</sup> The supplementary capital adequacy according to Method 1 can be expressed in the following formula:

$$SCA = OF_{\text{Consolidated}} - (S_{\text{Bank}} + S_{\text{Insurance}} + S_{\text{Investment}} + S_{\text{Nonregulated}}).^{105}$$

Because this method's starting point and basis are the fully consolidated accounts of the financial conglomerate, by definition, all intra-group on- and off-balance sheet accounts or exposures have been

eliminated and the effects of double or multiple gearing and excessive leverage are equated. Thus, calculating the group-wide capital adequacy simply consists of the deduction of the solvency requirements of the group's financial sectors from the consolidated own funds.

**Method 2.** The calculation of the supplementary capital adequacy pursuant to the deduction and aggregation method is carried out on the basis of the separate accounts of each entity in the group that is included in the calculation of capital adequacy. According to this method, the supplementary capital adequacy shall be calculated on the basis of the accounts of each of the entities in the group as the difference between the sum of the own funds of each regulated and nonregulated entity in the financial conglomerate;<sup>106</sup> and the sum of (i) the solvency requirements for each regulated and nonregulated entity in the group<sup>107</sup> and (ii) the book value of the participations in other entities of the group.<sup>108</sup> The supplementary capital adequacy according to Method 2 can be expressed in the following formula:

$$\text{SCA} = (\text{OF}_1 + \text{OF}_2 + \text{OF}_3 + \dots) - [(\text{S}_1 + \text{S}_2 + \text{S}_3 + \dots) + (\text{BV}_1 + \text{BV}_2 + \text{BV}_3 \dots)].^{109}$$

The effect of this method is to pretend the situation of consolidated accounts, and therefore to eliminate multiple gearing, excessive leverage, and the misuse of accounting margins relating to the book value of participations by deducting those participations.

**Method 3.** The requirement deduction method is based on the balance sheet of each entity within the group. According to this method, the calculation of the supplementary capital adequacy shall be carried out on the basis of the accounts of each of the entities in the group as the difference between the own funds of the parent undertaking or the entity at the head of the financial conglomerate<sup>110</sup> and the sum of (i) the solvency requirement of the relevant parent undertaking or the head and (ii) the higher of the book value of the parent undertaking's or the head's participation in other entities in the group and these entities' solvency requirement.<sup>111</sup> The supplementary capital adequacy

according to Method 3 can be expressed in the following formula:

$$\text{SCA} = \text{OF}_{\text{Parent}} - [\text{S}_{\text{Parent}} + (\text{BV}_1 \text{ or } \text{S}_1 + \text{BV}_2 \text{ or } \text{S}_2 + \text{BV}_3 \text{ or } \text{S}_3 + \dots)].^{112}$$

This method, which does not take into account the own funds of the subsidiaries, provides for an easy way to assess potential double gearing within the group.<sup>113</sup>

### ***Capital Policies and Supervision***

The member states shall require regulated entities to have in place adequate capital adequacy policies at the level of the financial conglomerate. The requirement that regulated entities in financial conglomerates must ensure that on the level of the financial conglomerates the capital adequacy requirements of Annex I are met and that regulated entities have in place adequate capital adequacy policies on the level of the financial conglomerate must be subject to supervisory overview by the coordinator. The regulated entities or the mixed financial holding company must calculate the sufficiency of own funds on the level of the financial conglomerate at least annually. The EU-regulated entity at the head of the financial conglomerate or the mixed financial holding company at the head of the financial conglomerate must submit the result of the calculation to the coordinator.<sup>114</sup>

One can question the rationale for requiring adequate capital for a financial conglomerate on the group level, because in case of need of a regulated entity in the group, the group capital is not available to the needy regulated entity. The Supplementary Supervision Directive does not establish what is known as a “source of strength doctrine.” Under that doctrine a U.S. bank holding company and indirectly its subsidiaries are expected to support a deposit-taking subsidiary in case of need. The Gramm-Leach-Bliley Act of 1999 amendments to the U.S. Bank Holding Company Act of 1956 affirm this doctrine with certain limitations.<sup>115</sup>

### **Intra-Group Transactions and Risk Concentration**

Another core regulation of the Supplementary Supervision Directive is the requirement of supplementary supervision on intra-group

transactions and risk concentration of regulated entities in a financial conglomerate.<sup>116</sup>

### ***Intra-Group Transactions***

Intra-group transactions may cause supervisory concerns when they (1) result in capital or income being inappropriately transferred from the regulated entity; (2) are on terms or under circumstances that parties operating at arm's length would not allow and may be disadvantageous to a regulated entity; (3) can adversely affect the solvency, the liquidity, and the profitability of individual entities within a group; or (4) are used as a means of supervisory arbitrage, thereby evading capital or other regulatory requirements altogether.<sup>117</sup> Monitoring intra-group transactions is also an important factor in dealing with the risk of contagion within a financial conglomerate. Contagion entails the risk that, if certain parts of a conglomerate are experiencing financial difficulties, they may infect other healthy parts of the conglomerate as a result of which the operation of the healthy parts may be hampered or even made impossible.<sup>118</sup> Therefore, intra-group transactions can significantly exacerbate problems for a regulated entity once contagion spreads.<sup>119</sup>

“Intra-group transactions” as defined in the Supplementary Supervision Directive are transactions by a regulated entity in a financial conglomerate with any other undertaking in the financial conglomerate.<sup>120</sup> However, intra-group transactions go beyond transactions with members of the group. Intra-group transactions include transactions “with natural or legal persons linked to the undertakings within the group by close links,” even though such linked persons are not members of the group, and, consequently, not members of the financial conglomerate.<sup>121</sup> The intra-group transactions are not limited to transactions of EU-regulated entities within a financial conglomerate but are transactions of any regulated entity.<sup>122</sup> The Supplementary Supervision Directive does not provide for quantitative limits or qualitative requirements with regard to intra-group transactions within a financial conglomerate. The introduction of such limits and requirements or the introduction of other supervisory measures that would achieve the objectives of supplementary supervision with regard to intra-group transactions is left to the member states.<sup>123</sup>

The scope of the provisions in the Supplementary Supervision Directive that deals with intra-group transactions is broader than the scope of the equivalent U.S. rules, Sections 23A and 23B, Federal Reserve Act,<sup>124</sup> because the Supplementary Supervision Directive applies to all transactions between all regulated entities within a financial conglomerate and other entities in the group,<sup>125</sup> whereas Sections 23A and 23B, Federal Reserve Act apply only to transactions between an insured depository institution, that is, a U.S. bank, and its affiliates.

### ***Risk Concentration***

As to the problem of risk concentration,<sup>126</sup> supervisors of the different financial sectors use various approaches to monitor large exposures, due to the different risks they are facing. In all three sectors, financial institutions face an increased risk of loss when their assets, liabilities, or business activities are not diversified. As not all risk concentrations are inherently bad (a certain degree of concentration is the inevitable result of a well-articulated business strategy as well as product specialization, the targeting of a customer base, or a sound strategy of outsourcing data processing activities), supervisors need to balance the benefits against the risks of concentrations at the conglomerate level. In identifying risks, the competent authorities have to take into account the different ways in which large losses can develop in a conglomerate as a result of risk concentration.<sup>127</sup>

Risk concentration means all exposures with a loss potential borne by entities (the exposures are not limited to those borne by regulated entities) within a financial conglomerate that are large enough to threaten the solvency, or the financial position in general, of the regulated entities in the financial conglomerate. Such exposures may be caused by counterparty risk/credit risk, investment risk, insurance risk, market risk, other risks, or a combination or interaction of these risks.<sup>128</sup>

Like in the case of intra-group transactions, the Supplementary Supervision Directive does not provide for quantitative limits or quantitative requirements with regard to risk concentration at the level of the financial conglomerate. The introduction of such limits and requirements or the introduction of other supervisory measures that

would achieve the objectives of supplementary supervision with regard to risk concentration is left to the member states.<sup>129</sup>

### ***Common Provisions***

To avoid the risks resulting from intra-group transactions and risk concentration, the member states shall require regulated entities to have in place at the level of the financial conglomerate adequate risk management processes and internal control mechanisms—including sound reporting and accounting procedures.<sup>130</sup> In addition, regulated entities that are Responsible Entities must have adequate internal control mechanisms for the production of any data and information that would be relevant for the purpose of supplementary supervision.<sup>131</sup>

In addition, the member states shall require regulated entities or mixed financial holding companies to report on a regular basis and at least annually to the coordinator any significant risk concentration at the level of the financial conglomerate and significant intra-group transactions of regulated entities within a financial conglomerate.<sup>132</sup> The necessary information shall be submitted to the coordinator by the EU-regulated entity that is at the head of the financial conglomerate or, where the financial conglomerate is not headed by an EU-regulated entity, by the mixed financial holding company or by the regulated entity in the financial conglomerate identified by the coordinator after consultation with the other relevant competent authorities and with the financial conglomerate.<sup>133</sup> The intra-group transactions and risk concentrations shall be subject to supervisory overview by the coordinator.<sup>134</sup> Therefore, the coordinator, after consultation with the other relevant competent authorities, shall identify the type of transactions and risks regulated entities in a particular financial conglomerate shall report in accordance with the provisions on reporting of intra-group transactions and risk concentration.<sup>135</sup> Thus, the Supplementary Supervision Directive provides for the development of reporting requirements that are specific for each financial conglomerate.

Where a financial conglomerate is headed by a mixed financial holding company, the sectoral rules regarding intra-group transactions and risk concentration of the most important financial sector in the

financial conglomerate shall apply to that sector as a whole, including the mixed financial holding company.<sup>136</sup>

### **Management Qualifications**

The Supplementary Supervision Directive requires the member states to provide that persons who effectively direct the business of a mixed financial holding company are of sufficiently good repute and have sufficient experience to perform their duties.<sup>137</sup> This provision is intended to ensure that a manager of a nonregulated entity having a dominant influence on the performance of a regulated entity is reliable, like a manager of the regulated entity, in particular as regards the management of the mixed financial holding company. This provision responds to the recent tendency to manage financial conglomerates along the different business lines of conglomerates instead of the traditional legal entity based approaches.<sup>138</sup> The Supplementary Supervision Directive also provides that the member states shall require that persons who effectively direct the business of an insurance holding company or a financial holding company are of sufficiently good repute and have sufficient experience to perform their duties.<sup>139</sup>

### **Measures to Facilitate Supplementary Supervision**

One of the principal objectives of the Supplementary Supervision Directive is the introduction of measures to facilitate supplementary supervision.<sup>140</sup> Supplementary supervision requires the exchange of information among the entities in the financial conglomerate and exchange of information and cooperation among the competent authorities involved in the supervision of regulated entities in a particular financial conglomerate.<sup>141</sup>

The Supplementary Supervision Directive introduces the so-called “coordinator.” The competent authorities of the member states concerned shall appoint from among them a coordinator responsible for the coordination and exercise of the supplementary supervision of the regulated entities in a financial conglomerate.<sup>142</sup> The Supplementary Supervision Directive provides for the automatic identification of the coordinator on the basis of objective criteria; however, the relevant competent authorities may waive by agreement these criteria and appoint a different competent authority as coordinator. The competent authorities shall give the financial conglomerate an opportunity to

state its opinion on that decision.<sup>143</sup> The coordinator functions merely as a *primus inter pares* of the competent authorities of the member states involved with the regulated entities of a financial conglomerate. A coordinator must be nominated not only for cross-border financial conglomerates but also for financial conglomerates that have several regulated entities in one member state and at least two supervisory authorities of that member state are involved.<sup>144</sup>

The tasks of the coordinator with regard to supplementary supervision are (1) the coordination of gathering and disseminating of relevant or essential information in going concern and emergency situations; (2) the supervisory overview and assessment of the financial situation of a financial conglomerate; (3) the assessment of compliance with the rules on capital adequacy, risk concentration, and intra-group transactions; (4) the assessment of the financial conglomerate's structure, organization, and internal control systems; (5) the planning and coordination of supervisory activities in going concern as well as in emergency situations, in cooperation with the relevant competent authorities involved; and (6) other tasks assigned to the coordinator by the Supplementary Supervision Directive or by coordination arrangements between the coordinator and other relevant competent authorities.<sup>145</sup>

The coordinator has no decision-making or enforcement authority to impose measures and sanctions. The presence of a coordinator entrusted with specific tasks concerning the supplementary supervision does not affect the tasks and responsibilities of the competent authorities responsible for the regulated entities in a financial conglomerate as provided for by the sectoral rules.<sup>146</sup>

To ensure proper supplementary supervision, the competent authorities responsible for the supervision of regulated entities in a financial conglomerate and the coordinator are required to cooperate closely with each other.<sup>147</sup> The coordinator and the relevant competent authorities may enter into coordination agreements to specify the procedures for the decision-making process and for cooperation among them.<sup>148</sup> They shall provide each other with any information that is essential or relevant for the exercise of the other competent authorities' supervisory tasks under the sectoral rules and under the Supplementary Supervision Directive. The competent authorities and the coordinator shall communicate on request all relevant information



and shall communicate on their own initiative all essential information.<sup>149</sup> The competent authorities shall consult with each other prior to their decision with regard to the following items, where these decisions are important for the supervisory tasks of other competent authorities: (1) changes in the shareholder, organizational, or management structure of regulated entities in a financial conglomerate that require the approval or authorization of competent authorities; and (2) major sanctions or exceptional measures taken by the competent authorities.<sup>150</sup>

If a competent authority wishes to verify information concerning an entity in a financial conglomerate, whether or not it is a regulated entity, that is situated in another member state, it may ask the competent authorities of the other member state to carry out the verification. The requested competent authority must carry out the verification or permit experts or the requesting authority to carry out the verification.<sup>151</sup>

### **Equivalent Supplemental Supervision for Parent Undertakings Outside the European Union**

If the parent of a financial conglomerate is a regulated entity or a mixed financial holding company having its head office outside the European Union, the EU-regulated entities belonging to such a “non-EU group” are not directly subject to the rules on supplementary supervision.<sup>152</sup> The Supplementary Supervision Directive, however, attempts to apply as much supplementary supervision as possible.<sup>153</sup>

The Supplementary Supervision Directive requires a verification whether the EU-regulated entity, the parent of which has its head office outside the European Union, is subject to supervision by the home country of the parent that is equivalent to the supplementary supervision of regulated entities provided for in the Supplementary Supervision Directive. The verification shall be carried out by the competent authority that would be the coordinator if the criteria for the appointment of the coordinator as set forth in the Supplementary Supervision Directive were to apply (hereinafter the hypothetical coordinator). The verification shall be carried out on the request of the parent of the financial conglomerate, by an EU-regulated entity in such financial conglomerate, or by the hypothetical coordinator.<sup>154</sup>

The hypothetical coordinator shall consult the other relevant competent authorities and the Financial Conglomerates Committee,<sup>155</sup> and shall take into account any applicable guidance prepared by the Financial Conglomerates Committee.<sup>156</sup>

When the U.S. regulations under the BHCA require foreign banks to demonstrate that they are subject to comprehensive supervision on a consolidated basis,<sup>157</sup> they address the question of whether the foreign bank itself is properly supervised by its home country. The Supplementary Supervision Directive, on the other hand, asks whether the EU-regulated entities are subject to supervision by the non-EU home country of the non-EU parent of the financial conglomerate and whether such supervision is equivalent to the supervision under the Supplementary Supervision Directive.

If the supervision by the home country of the non-EU-regulated entity or the mixed financial holding company that has its head office outside the European Union over the EU-regulated entities in such group is found to be equivalent to the supplementary supervision of the Supplementary Supervision Directive, the Supplementary Supervision Directive will yield to the foreign supervision.

In the absence of such equivalent supervision, the member states shall by analogy apply to the EU-regulated entities the provision with regard to supplementary supervision.<sup>158</sup> In the alternative, the member states shall allow their competent authorities to apply other methods that ensure an appropriate supplementary supervision of the EU-regulated entities in a financial conglomerate.<sup>159</sup> In particular, the competent authorities may require the creation of a subholding company (which would be a mixed financial holding company) that has its head office in the European Union, and apply the supplementary supervision required by the Supplementary Supervision Directive to the regulated entities in the financial conglomerate headed by the European subholding company. In any event, the methods selected by the competent authorities to ensure an appropriate supplementary supervision “must achieve the objectives of the supplementary supervision as defined in the [Supplementary Supervision Directive]” and must be notified to the competent authorities involved and the EU Commission.<sup>160</sup>

For a U.S. observer, it is quite surprising to note that the Supplementary Supervision Directive hesitates to regulate directly non-EU holding companies of EU-regulated entities. The U.S. banking legislation does not show such hesitation with respect to foreign holding companies. For example, the U.S. Bank Holding Company Act of 1956 (BHCA) applies not only to U.S. banks but also to foreign banks that control a U.S. bank subsidiary<sup>161</sup> and foreign banks that maintain a branch, agency, or commercial lending company in the United States.<sup>162</sup>

The EU Commission may also negotiate agreements with third countries regarding the means of exercising supplementary supervision of regulated entities in a financial conglomerate.<sup>163</sup> In this context, the EU Commission may submit proposals to the EU Council, either at the request of a member state or on its own initiative, for the negotiation of such agreements. The agreements would cover supplementary supervision of financial conglomerates whose parent is situated outside the European Union but that have regulated entities in the European Union and of financial conglomerates whose parent is situated in the European Union but that have regulated entities outside the European Union.<sup>164</sup>

### **Equivalent Consolidated Supervision and Supplementary Supervision of Groups Headed by U.S. Entities**

If the parent of a financial conglomerate is a regulated entity or a mixed financial holding company having its head office outside the European Union, the competent authorities must verify whether the EU-regulated entities in the financial conglomerate are subject to supplementary supervision by the home country of the parent that is equivalent to the supplementary supervision required by the Supplementary Supervision Directive.<sup>165</sup> The question arises whether an EU-regulated credit institution, investment firm, or insurance undertaking subsidiary that is part of a cross-sectoral financial conglomerate headed by a U.S. parent is subject to equivalent supplementary supervision under U.S. law.

Supplementary supervision applies to financial conglomerates that straddle several financial sectors. Supplementary supervision under the Supplementary Supervision Directive applies to capital adequacy at the level of the financial conglomerate, intra-group

transactions by regulated entities in a financial conglomerate with other undertakings in the financial conglomerate, and risk concentration in the financial conglomerate.

### **Financial Holding Companies**

In the United States financial conglomerates are permitted subject to various restrictions by the Gramm-Leach-Bliley Act of 1999 (GLBA) amendments to the BHCA.<sup>166</sup> These amendments permit the creation of financial holding companies (FHCs) that have investments in several financial sectors, mainly the banking, insurance, and broker-dealer sectors.

Whereas the Supplementary Supervision Directive was promulgated to impose additional supervision on cross-sectoral financial conglomerates to deal with the specific risks of such financial conglomerates, the BHCA was enacted to prevent circumvention of the rule of separation of banking from all other commercial activities through the creation of a holding company. Even the GLBA amendments to the BHCA, which permit financial holding companies, are more concerned with the careful delineation of this new permission of banks to affiliate with nonbank financial companies than with the supervision of the newly permitted financial conglomerates. Furthermore, different from the Supplementary Supervision Directive, the GLBA was written to protect the banks in financial holding company groups, not to deal with the specific risks of such groups. The GLBA gives the Federal Reserve Board an “umbrella supervision”<sup>167</sup> over the financial holding company. It remains to be seen whether this umbrella authority will lead to a true supervision of the conglomerate as such.

### ***Capital Adequacy***

The Board of Governors of the Federal Reserve System (the Board) has the authority, based on its general supervisory power over bank holding companies (BHCs), to impose capital and capital adequacy requirements on BHCs. This authority does not diminish once the BHC has effectively elected FHC status.<sup>168</sup> Although Regulation Y does not contain any specific requirement that, as a condition to the effective election of FHC status, a U.S. BHC must meet the capital requirements applicable to all BHCs, there is no doubt that the Board

under its general supervisory power over BHCs could deny the effectiveness of an FHC election by a BHC, if the BHC is in violation of applicable laws and regulations, including the rules of capital adequacy.<sup>169</sup> The Board may impose capital requirements on a BHC/FHC, not only if it is a mere holding company without its own business activities, but, according to the BHCA, even if the BHC/FHC is a broker-dealer, insurance company, insurance agent, or investment company.<sup>170</sup> It is not clear, however, how the capitalization of a company engaged in financial activities other than banking, for example, a broker-dealer or an insurance company, can be computed in accordance with the Basel Capital Standards, and—unlike the Supplementary Supervision Directive—the Board has not attempted to develop capital adequacy standards for FHCs that are not mere BHCs.<sup>171</sup>

### ***Intra-Group Transactions***

The supplementary supervision of intra-group transactions under the Supplementary Supervision Directive covers all transactions in which EU-regulated or non-EU-regulated entities are involved. In the United States certain regulatory concerns, such as intra-group transactions and risk concentration, are left to the regulators of the constituent parts of the FHC. Transactions between an insured depository institution and its affiliates are subject to strict limitations under Sections 23A and 23B, Federal Reserve Act.<sup>172</sup> A bank's direct and indirect parent companies, as well as companies controlled by or under common control with the banks, are covered as affiliates.<sup>173</sup> Sections 23A and 23B, Federal Reserve Act deal only with transactions in which the insured U.S. bank is involved.

Transactions between a U.S. insurance company and other companies in an insurance holding company system may be subject to supervision under state insurance laws. For instance, under the New York Insurance Law intra-group transactions of controlled insurers<sup>174</sup> with other entities in an insurance holding company system<sup>175</sup> are subject to certain substantive standards. Section 1505, New York Insurance Law provides that transactions within a holding company system to which a controlled insurer is a party must be on fair and equitable terms, charges or fees for services performed must be reasonable, and expenses incurred and payments received must be allocated to the insurer on an equitable basis in accordance with

customary insurance accounting practices consistently applied.<sup>176</sup> Certain intra-group transactions between a domestic controlled insurer and any person in its holding company system require approval of the Superintendent of Insurance<sup>177</sup> and in the case of other transactions between a domestic controlled insurer and any person in its holding company system, prior notice to the Superintendent is required.<sup>178</sup> The books and records of each party to intra-group transactions must clearly and accurately disclose the nature and details of such transactions.<sup>179</sup> Every controlled insurer must annually report to the Superintendent of Insurance all transactions during the preceding fiscal year with persons within the holding company system.<sup>180</sup> Again, some of these provisions deal only with intra-group transactions involving a U.S. insurer.<sup>181</sup>

There are no rules dealing with intra-group transactions of U.S. broker-dealers, that is, investment firms in the terminology of the Supplementary Supervision Directive.<sup>182</sup>

### ***Risk Concentration***

The Board has stated that as “umbrella supervisor” of FHCs it will assess capital adequacy of FHCs in relation to the risk profile of the consolidated organization and that the Board will review the FHC’s internal risk assessment and related capital analysis process for determining the adequacy of its overall capital position.<sup>183</sup> Such review will include consideration of present and future economic conditions, future business development plans, possible stress scenarios, and Internet risk control and audit procedures.<sup>184</sup>

### **Consolidated Supervised Entities**

The U.S. Securities and Exchange Commission (SEC) recognizes that large broker-dealers typically are owned by holding companies that also own other entities engaged in securities and nonsecurities activities worldwide and that the broker-dealer may incur many types of risks through its affiliations. In recently adopted rules the SEC took a step in the direction of supervision of groups that include broker-dealers.<sup>185</sup> These rules permit a holding company system that includes a broker-dealer (the ultimate holding company and its affiliates are called a “consolidated supervised entity” (hereinafter CSE)) to voluntarily submit to group-wide SEC supervision. The rules were

adopted in response to the EU requirement of equivalent supplementary supervision in the Supplementary Supervision Directive.<sup>186</sup>

The ultimate holding company of the CSE must have a group-wide internal risk management control system and must agree to provide the SEC with additional information about the financial condition of the ultimate holding company and its affiliates.

For an ultimate holding company that does not have a principal regulator, this financial information includes a monthly computation of group-wide allowable capital and allowances for market, credit, and operational risk calculated in accordance with the Basel Capital Standards. This type of ultimate holding company also must provide the SEC with specified financial, operational, and risk management information on a monthly, quarterly, and annual basis. Moreover, an ultimate holding company that does not have a principal regulator must implement and maintain a consolidated internal risk management control system and procedures to monitor and manage group-wide risk, including market, credit, funding, operational, and legal risks, and make and maintain certain books and records. Both the ultimate holding company and its affiliates that do not have principal regulators must consent to SEC examination.<sup>187</sup>

An ultimate holding company that has a principal regulator is subject to substantially fewer requirements than one that does not have a principal regulator. This category of ultimate holding company must consent to provide the SEC, on a quarterly basis, with the capital measurements that it submits to its principal regulator, consolidated and consolidating balance sheets and income statements, and certain regular risk reports provided to the persons responsible for managing group-wide risk. Annually, an ultimate holding company that has a principal regulator must provide audited consolidated balance sheets and income statements and capital measurements, as submitted to its principal regulator. An ultimate holding company that has a principal regulator also is subject to more limited undertaking and information requirements related to the broker-dealer's application for exemption from the standard net capital rule as well as reduced notification and record keeping requirements.<sup>188</sup>

The SEC will not examine an entity that has a principal regulator and will use the reports that such entity files with its principal regulator to the greatest extent possible.<sup>189</sup>

In the CSE rules the SEC carefully tries to walk the line between supervision of the group and deference to other regulatory agencies. The proposed CSE rules—different from the Supplementary Supervision Directive—do not envision the role of a coordinator to facilitate supervision of entities in different sectors of the financial industry.

If the CSE of a broker-dealer submits to SEC supervision and complies with the CSE requirements, the broker-dealer in the group may apply to the SEC for an exception from the application of the standard net capital rules and may elect to calculate certain of its market and credit risk capital charges using the firm's own internal mathematical models for risk measurement, including internally developed value-at-risk models and scenario analysis.<sup>190</sup>

### **Supervised Investment Bank Holding Companies**

Section 231, GLBA amended Section 17, Securities Exchange Act of 1934 (hereinafter Exchange Act)<sup>191</sup> to create a regulatory framework under which a holding company of a broker-dealer may voluntarily elect to be supervised by the SEC as a supervised investment bank holding company (hereinafter SIBHC).

The SEC recently adopted rules to implement Section 17<sup>192</sup> to create a framework for supervising an investment bank holding company that voluntarily files a notice of intention with the SEC to become an SIBHC and to be subject to supervision on a group-wide basis. These rules also enhance the SEC's supervision of the SIBHC's subsidiary broker-dealers through collection of additional information and examinations of affiliates of those broker-dealers. This framework includes qualification criteria for investment bank holding companies that file notices of intention to be supervised by the SEC, as well as record keeping and reporting requirements for SIBHCs. An investment bank holding company that meets the criteria set forth in the rules is not required to become an SIBHC; supervision as an SIBHC is voluntary.<sup>193</sup> Taken as a whole, the framework permits the SEC to better monitor the financial condition, risk management, and activities of an SIBHC and its affiliates (including broker-dealer af-



filiates) on a group-wide basis. This regulatory framework for SIBHCs is intended to provide a basis for non-U.S. financial regulators to treat the SEC as the principal U.S. consolidated, home-country supervisor for SIBHCs and their affiliates.<sup>194</sup>

Pursuant to the definitions in the Exchange Act,<sup>195</sup> the term “investment bank holding company” means any person, other than a natural person, that owns or controls one or more broker-dealers and the associated persons of the investment bank holding company. The term “associated person of an investment bank holding company” means any person directly or indirectly controlling, controlled by, or under common control with the investment bank holding company.<sup>196</sup> Thus, an investment bank holding company includes the holding company and all other entities within the holding company structure that met the “control” test.

Section 17(i)(1)(A), Exchange Act<sup>197</sup> limits the entities that are eligible to become an SIBHC. Specifically, an investment bank holding company that is (1) an affiliate of an insured bank (with certain exceptions) or a savings association; (2) a foreign bank, foreign company, or a company that is described in Section 8(a), International Banking Act of 1978; or (3) a foreign bank that controls, directly or indirectly, an Edge Act corporation<sup>198</sup> would not be eligible to file a notice of intention.<sup>199</sup> These exclusions of groups that include banks prevent FHCs from electing SIBHC status and substantially limit the number of financial groups that can elect SIBHC status.

Rule 17i-4 requires an SIBHC to establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, operational, funding, and legal risks.<sup>200</sup> Pursuant to Section 17(i)(3)(A), Exchange Act,<sup>201</sup> an SIBHC would be required to make and keep records, furnish copies thereof, and make such reports as the SEC may require by rule.<sup>202</sup> Rule 17i-7 requires an SIBHC to calculate the affiliate group’s allowable capital and allowances for market, credit, and operational risks on a consolidated basis consistent with the Basel Capital Standards. Rule 17i-7 does not set minimum group-wide capital levels for SIBHCs; rather, it requires the SIBHC to perform certain calculations that the SEC will review to gain an understanding of the financial position of the affiliate group and identify any risks it poses to the broker-dealer or other market partici-

pants.<sup>203</sup> The rules incorporate a capital computation for the SIBHC that is consistent with the Basel Capital Standards.<sup>204</sup>

## Notes

<sup>1</sup> Directive 2002/87/EC of the European Parliament and of the Council of December 16, 2002 on the supplementary supervision of credit institutions, insurance undertakings, and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC, and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council, O.J. Eur. Comm. No. L 35/1 (2003) [hereinafter the Supplementary Supervision Directive]. For a detailed discussion of the Supplementary Supervision Directive, see Michael Gruson, “Consolidated and Supplementary Supervision of Financial Groups in the European Union,” 2004 *Der Konzern* 65 (Part I), 249 (Part II) [hereinafter Gruson, “Consolidated and Supplementary Supervision”]; Michael Gruson, “Supervision of Financial Holding Companies in Europe: The EU Directive on Supplementary Supervision of Financial Conglomerates,” 36 *International Lawyer* 1229 (2002).

<sup>2</sup> Recitals (2) and (3), Supplementary Supervision Directive.

<sup>3</sup> Explanatory Memorandum to the Proposed Supplementary Supervision Directive (April 24, 2001), O.J. Eur. Comm. No. C 213/227 (2001) [hereinafter 2001 Explanatory Memorandum], at 2 *sub* 1.

<sup>4</sup> Tripartite Group of Bank, Securities and Insurance Regulators, *The Supervision of Financial Conglomerates* (Bank for International Settlements, July 1995) [hereinafter Tripartite Report], at 39, *sub* no. 104; The Joint Forum, *The Joint Forum Compendium of Documents* (July 2001) [hereinafter Joint Forum Report], *Capital Adequacy Principles Paper*, at 12, *sub* no. 6. The Tripartite Group was formed at the initiative of the Basel Committee on Banking Supervision (Basel Committee) in early 1993 to address a range of issues relating to the supervision of financial conglomerates. The Joint Forum was established in early 1996 under the aegis of the Basel Committee, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) to take forward the work of the Tripartite Group. The Joint Forum Report is a compilation of papers that have been prepared by the Joint Forum since its inception in January 1996.

<sup>5</sup> Tripartite Report, at 16, *sub* no. 41.

<sup>6</sup> 2001 Explanatory Memorandum, at 2, *sub* 1.

<sup>7</sup> Tripartite Report, at 16, *sub* no. 42.

<sup>8</sup> For a detailed discussion of consolidated supervision of banking groups and investment firm groups, see Gruson, “Consolidated and Supplementary Supervision,” at 66.

<sup>9</sup> Directive 2000/12/EC of the European Parliament and of the Council of March 20, 2000 relating to the taking up and pursuit of the business of credit institutions, O.J. Eur. Comm. No. L 126/1 (2000), as amended [hereinafter Banking Directive].

<sup>10</sup> Art. 1(1), Banking Directive.

<sup>11</sup> Art. 1(5), Banking Directive. A *financial institution* is an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on most of the activities that a credit institution may engage in, other than deposit taking. Investment firms are financial institutions.

<sup>12</sup> Defined in Art. 1(13), second subparagraph, Banking Directive by reference to Art. 1(1), Consolidated Accounts Directive, *infra* note 46. *Subsidiary* is, in summary, an undertaking (1) in which a parent (a) has, or controls alone, pursuant to a shareholder agreement, a majority of the shareholders’ or members’ voting rights, or (b) has the right to appoint or remove a majority of the members of the administrative, management, or supervisory board and is at the same time a shareholder or a member; or (2) that can be controlled by the parent (the parent “has the right to exercise a dominant influence”) pursuant to a contract between the parent and the subsidiary or a provision in the subsidiary’s charter, the parent at the same time being a shareholder or a member. In addition, a subsidiary is any undertaking over which, in the opinion of the competent authorities, a parent effectively exercises a dominant influence.

<sup>13</sup> Art. 1(9), Banking Directive (essentially 20 percent or more of the voting rights or capital; a lower percentage suffices if the investment, by creating a durable link between the investor and the target, is intended to contribute to the investor’s activities).

<sup>14</sup> Art. 52(1) and (2), Banking Directive. Art. 1(21), Banking Directive, as amended by Art. 29(1)(b), Supplementary Supervision Directive, defines *financial holding company* as a financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, at least one of such subsidiaries being a credit institution, and which is not a mixed financial holding company within the meaning of [the Supplementary Supervision Directive].

<sup>15</sup> Art. 7(2) and (3), Council Directive 93/6/EEC of March 15, 1993 on the capital adequacy of investment firms and credit institutions, O.J. Eur.

Comm. No. L 141/1 (1993), as amended [hereinafter Capital Adequacy Directive].

<sup>16</sup> Art. 7(2) and (3), Capital Adequacy Directive. “Financial holding company” is defined in Art. 2(8), Capital Adequacy Directive as any financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions, investment firms, or other financial institutions, at least one of which is a credit institution or an investment firm.

<sup>17</sup> Art. 2(2), Capital Adequacy Directive.

<sup>18</sup> Art. 52(5) and (6), Banking Directive; Art. 7(2), Capital Adequacy Directive.

<sup>19</sup> Art. 7(3), 5th indent, Capital Adequacy Directive that excludes the application of Art. 52(5), second subparagraph, Banking Directive. Investment firms are not restricted to their investments in the industrial or commercial sector.

<sup>20</sup> Art. 25(1), Banking Directive. Art. 25, Banking Directive is not applicable to investment firms, and the Capital Adequacy Directive does not contain similar provisions.

<sup>21</sup> Art. 56a, first subparagraph, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive. Art. 56a, Banking Directive also applies to investment firm groups. Art. 7(2) and (3), Capital Adequacy Directive.

<sup>22</sup> Art. 56a, fifth subparagraph, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive.

<sup>23</sup> Art. 56a, fifth subparagraph, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive.

<sup>24</sup> Directive 98/78/EC of the European Parliament and of the Council of October 27, 1998 on the supplementary supervision of insurance undertakings in an insurance group, O.J. Eur. Comm. No. L 330/1 (1998), as amended [hereinafter Insurance Group Directive]. For a discussion of supplementary supervision of insurance groups, see Gruson, “Consolidated and Supplementary Supervision,” at 75.

<sup>25</sup> Art. 1(a), Insurance Group Directive.

<sup>26</sup> Art. 1(e), Insurance Group Directive.

<sup>27</sup> Art. 1(c), Insurance Group Directive.

<sup>28</sup> Art. 1(b), Insurance Group Directive.

<sup>29</sup> Art. 1(f), Insurance Group Directive.

<sup>30</sup> Art. 2(1), Insurance Group Directive. A horizontal structure exists if there is control in the absence of an equity investment, due to management on a unified basis or cross-membership of governing boards. *See* Art. 1(g), Insurance Group Directive.

<sup>31</sup> Art. 1(d), Insurance Group Directive.

<sup>32</sup> “Insurance holding company” is a parent the main business of which is to acquire and hold participations in subsidiaries, where those subsidiaries are exclusively or mainly EU-authorized insurance undertakings, reinsurance undertakings or non-EU insurance undertakings, at least one of such subsidiaries being an EU-authorized life or non-life insurance undertaking, and which is not a mixed financial holding company within the meaning of the Supplementary Supervision Directive. Art. 1(i), Insurance Group Directive.

<sup>33</sup> Art. 2(2), Insurance Group Directive.

<sup>34</sup> Art. 2(3), Insurance Group Directive. “Mixed-activity insurance holding company” is a parent, other than an EU-authorized insurance undertaking, a non-EU insurance undertaking, a reinsurance undertaking, an insurance holding company, or a mixed financial holding company as defined in the Supplementary Supervision Directive, that includes at least one EU-authorized life or non-life insurance undertaking among its subsidiaries. Art. 1(j), Insurance Group Directive.

<sup>35</sup> Art. 8(1), Insurance Group Directive.

<sup>36</sup> Art. 9(1), referring to Art. 2(1), Insurance Group Directive.

<sup>37</sup> Art. 5(1), Insurance Group Directive.

<sup>38</sup> Art. 10b, Insurance Group Directive, added by Art. 28(4), Supplementary Supervision Directive.

<sup>39</sup> *E.g.*, Art. 55(2) and Art. 56(4), Banking Directive, Art. 7(3), 8th indent, Capital Adequacy Directive, and Art. 7(2), Insurance Group Directive in certain cases requires cooperation and exchange of information between the different supervisory authorities of different sectors.

<sup>40</sup> Art. 2(4), Supplementary Supervision Directive.

<sup>41</sup> Art. 6, First Council Directive 73/239/EEC of July 24, 1973 on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance, O.J. Eur. Comm. No. L 228/3 (1973), as amended [hereinafter First Non-Life Insurance Directive]; Art. 6, First Council Directive 79/267/EEC of March 5, 1979 on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of direct

life assurance, O.J. Eur. Comm. No. L 63/1 (1979), as amended [hereinafter First Life Insurance Directive]; Art. 3(1), Council Directive 93/22/EEC of May 10, 1993 on investment services in the securities field, O.J. Eur. Comm. No. L 141/27 (1993), as amended [hereinafter Investment Services Directive]; Art. 5(1), Directive 2004/39/EC of the European Parliament and of the Council of April 21, 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [hereinafter Financial Instruments Markets Directive]; Art. 4, Banking Directive.

<sup>42</sup> See Art. 1 and Art. 5(1), Supplementary Supervision Directive. The Supplementary Supervision Directive uses the term “regulated entity” with two meanings: As defined in Art. 2(4), Supplementary Supervision Directive, the term also includes non-EU-authorized entities. As used in Art. 1, Supplementary Supervision Directive, the term “regulated entities” refers only to entities that have obtained an authorization under a sectoral Directive. The Supplementary Supervision Directive calls EU-authorized regulated entities regulated entities referred to in Article 1. See, e.g., Art. 5(1), Supplementary Supervision Directive. Regulated entities referred to in Article 1 are hereinafter sometimes called “EU-regulated entities” and regulated entities that are not EU-regulated entities are hereinafter sometimes called “non-EU-regulated entities.”

<sup>43</sup> Art. 6, First Non-Life Insurance Directive and Art. 6, First Life Insurance Directive require an authorization of insurance undertakings having established their head office within the territory of a member state. Art. 3(1), in connection with Art. 1(6), Investment Services Directive states that only investment firms having their registered office or head office in a member state are subject to authorization. Art. 5(1), in conjunction with Art. 4(20), Financial Instruments Markets Directive provides that the member state in which the registered office is situated shall grant the necessary authorization for an investment firm. Although Art. 4, Banking Directive provides for the authorization of credit institutions prior to commencement of activities in a member state without expressly referring to the head office or registered office of that credit institution, it is clear from the context of the Banking Directive and Arts. 23–25, Banking Directive (governing relations with third countries) that only credit institutions established under the laws of a member state are subject to authorization pursuant to Art. 4, Banking Directive.

<sup>44</sup> Art. 5(1), Supplementary Supervision Directive.

<sup>45</sup> Art. 1, Supplementary Supervision Directive.

<sup>46</sup> “Parent undertaking” and “subsidiary undertaking” are defined in Art. 2(9) and (10), Supplementary Supervision Directive by reference to Art. 1(1) and (2), Seventh Council Directive 83/349/EEC of June 13, 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts, O.J. Eur. Comm. No. L 193/1 (1983), as amended [hereinafter Consolidated Accounts Directive]. The definitions of “parent” and “subsidiary” are identical with the definitions of such terms in the Banking Directive, except that the Supplementary Supervision Directive (but not the Banking Directive) permits member states to consider an undertaking as a parent undertaking if it has the power to exercise, or actually exercises, a dominant influence or control over another undertaking (a subsidiary) or manages another undertaking (the subsidiary) and the parent on a unified basis. *See* Art. 1(2), Consolidated Accounts Directive that is included in the subsidiary/parent definition of the Supplementary Supervision Directive, but not in those definitions of the Banking Directive.

<sup>47</sup> “Participation” is defined in Art. 2(11), Supplementary Supervision Directive, referring to Art. 17, first sentence, Fourth Council Directive 78/660/EEC of July 25, 1978 based on Art. 54(3)(g) of the Treaty on the annual accounts of certain types of companies, O.J. Eur. Comm. No. L 222/11 (1978), as amended [hereinafter Annual Accounts Directive]. A *participation* is (1) a right in the capital of other undertakings which “by creating a durable link with those [other] undertakings, are intended to contribute to the company’s [the holder of the participation] activities,” *or* (2) the ownership, directly or indirectly, of 20 percent or more of the voting rights or capital of another undertaking.

<sup>48</sup> Art. 2(12), Supplementary Supervision Directive, referring to Art. 12(1), Consolidated Accounts Directive.

<sup>49</sup> Section 2, Bank Holding Company Act of 1956, as amended [hereinafter BHCA], 12 U.S.C. § 1841 (2000). *See* Michael Gruson, “Nonbanking Activities of Foreign Banks Operating in the United States” [hereinafter Gruson, “Nonbanking Activities”], § 9.03 in Michael Gruson and Ralph Reisner, eds., *Regulation of Foreign Banks*, Vol. 1 (4th ed., 2003).

<sup>50</sup> Art. 2(14)(e), Supplementary Supervision Directive.

<sup>51</sup> Art. 2(14)(c), Supplementary Supervision Directive.

<sup>52</sup> *Compare* Art. 2(15) with Art. 5(2)(b), Supplementary Supervision Directive. If the head of a financial conglomerate is a non-EU-regulated entity, it is not a mixed financial holding company. *See* Art. 5(3), Supplementary Supervision Directive.

<sup>53</sup> *See* Art. 5(2)(b), Supplementary Supervision Directive.



<sup>54</sup> See Art. 2(14), in connection with Art. 5(2), Supplementary Supervision Directive. Art. 5(2)(a), Supplementary Supervision Directive refers to regulated entities in Art. 5(1), Supplementary Supervision Directive which covers only EU-authorized regulated entities (regulated entities referred to in Art. 1, Supplementary Supervision Directive).

<sup>55</sup> See Art. 5(3) and Art. 18, Supplementary Supervision Directive. The Supplementary Supervision Directive does not address the case of a horizontal group of which one member has its head office outside the European Union.

<sup>56</sup> Art. 52(1) and (2), Banking Directive.

<sup>57</sup> Art. 1(22), Banking Directive.

<sup>58</sup> Art. 1(5), Banking Directive.

<sup>59</sup> Art. 1(21), Banking Directive.

<sup>60</sup> Art. 52(2), Banking Directive.

<sup>61</sup> It must be noted, however, that the “mainly” test for purposes of the definition of a financial holding company differs from the “mainly” test for purposes of the definition of a mixed financial holding company: a financial holding company must exclusively or mainly hold credit institution or financial institution subsidiaries, whereas a group headed by a mixed financial holding company must mainly be engaged in the financial sector based on the 40 percent test.

<sup>62</sup> Art. 5(4), first subparagraph, Supplementary Supervision Directive.

<sup>63</sup> Art. 5(4), second subparagraph, Supplementary Supervision Directive.

<sup>64</sup> Art. 4(2), Supplementary Supervision Directive.

<sup>65</sup> *Id.*

<sup>66</sup> Art. 5(2), Supplementary Supervision Directive. See, e.g., Arts. 6(2), 7(2), and 9(1), Supplementary Supervision Directive.

<sup>67</sup> Arts. 6(2), 7(2), and 8(2), Supplementary Supervision Directive.

<sup>68</sup> Art. 5(2)(a) and (b), Supplementary Supervision Directive.

<sup>69</sup> See, e.g., Arts. 6(2), 7(2), 8(2), and 9(1), Supplementary Supervision Directive.

<sup>70</sup> Art. 5(5), Supplementary Supervision Directive.

<sup>71</sup> See, e.g., Art. 6(2), fourth and fifth subparagraphs, Art. 7(2) and Art. 8(2), second subparagraph, Supplementary Supervision Directive.

<sup>72</sup> See Art. 5(5), Supplementary Supervision Directive.

<sup>73</sup> Art. 2(18), Supplementary Supervision Directive.

<sup>74</sup> Art. 2(19), Supplementary Supervision Directive.

<sup>75</sup> Art. 6(3), Supplementary Supervision Directive.

<sup>76</sup> Art. 5(5), Supplementary Supervision Directive.

<sup>77</sup> Art. 5(2)(a), Supplementary Supervision Directive.

<sup>78</sup> *See* Art. 5(2), Supplementary Supervision Directive.

<sup>79</sup> Art. 2(15), Supplementary Supervision Directive.

<sup>80</sup> Art. 5(3) and Art. 18, Supplementary Supervision Directive.

<sup>81</sup> Arts. 6–17, Supplementary Supervision Directive.

<sup>82</sup> Art. 5(2), second subparagraph, Supplementary Supervision Directive.

<sup>83</sup> *See* Art. 2(14)(c), Supplementary Supervision Directive. The entity heading the group is not a mixed financial holding company if the group does not constitute a financial conglomerate. *See* Art. 2(15), Supplementary Supervision Directive.

<sup>84</sup> The prohibition of separate regulation of subgroups set forth in Art. 5(2), second subparagraph, Supplementary Supervision Directive does not apply in that case because the subgroup is not a subgroup of another financial conglomerate.

<sup>85</sup> *See* 2001 Explanatory Memorandum, at 6, *sub* 2, Art. 4, and Tripartite Report, at 36, *sub* no. 96 (the impression that the activities of unregulated entities in the financial conglomerate are in some way being monitored or supervised, even if only informally, creates a moral hazard).

<sup>86</sup> Art. 5(5) and Art. 12(4), Supplementary Supervision Directive.

<sup>87</sup> Art. 30, first and second subparagraphs, Supplementary Supervision Directive.

<sup>88</sup> Art. 30, third subparagraph, Supplementary Supervision Directive.

<sup>89</sup> Art. 10 and Art. 11, Supplementary Supervision Directive.

<sup>90</sup> Art. 12, Supplementary Supervision Directive.

<sup>91</sup> Tripartite Report, at 17, *sub* no. 43.

<sup>92</sup> Art. 6(1), Supplementary Supervision Directive.

<sup>93</sup> Annex I, *sub* I, 2(i), Supplementary Supervision Directive.

<sup>94</sup> Double gearing occurs whenever one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet; multiple gearing occurs when the dependent in the previous instance itself downstreams regulatory capital to a third-tier entity, and the parent's externally generated capital is geared up a third time. Annex I, *sub I, 2(i)*, Supplementary Supervision Directive refers to multiple gearing as the multiple use of elements eligible for the calculation of own funds at the level of the financial conglomerate. See Joint Forum Report, *Capital Adequacy Principles Paper*, at 13, *sub no. 18*.

<sup>95</sup> See 2001 Explanatory Memorandum, at 4, *sub 1(b)*. The Joint Forum Report, *Capital Adequacy Principles Paper*, at 14, *sub no. 23*, defines *excessive leverage* as situations where a parent issues debt (or other instruments not acceptable as regulatory capital in the downstream entity) and downstreams the proceeds as equity or other forms of regulatory capital to its regular subsidiaries.

<sup>96</sup> Tripartite Report, at 17, *sub no. 44*.

<sup>97</sup> Art. 6(2), first subparagraph, in connection with Art. 5(2), Supplementary Supervision Directive.

<sup>98</sup> Art. 6(3), Supplementary Supervision Directive.

<sup>99</sup> See Annex I, *sub II, Method 1, fourth paragraph, Method 2, third paragraph, and Method 3, third paragraph*, Supplementary Supervision Directive. "Notional solvency requirement" means the capital requirement with which such an entity would have to comply under the relevant sectoral rules as if it were a regulated entity of that particular financial sector; a mixed financial holding company shall be treated according to the sectoral rules of the most important financial sector in the financial conglomerate. In the case of asset management companies, solvency requirements means the capital requirement set out in Art. 5a(1)(a), 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), O.J. Eur. Comm. No. L 375/3 (1985), as amended [hereinafter UCITS Directive]. Annex I, *sub I, 2(ii)*, last paragraph, Supplementary Supervision Directive.

<sup>100</sup> Annex I, *sub I, 2(ii)*, first paragraph, Supplementary Supervision Directive.

<sup>101</sup> Annex I, *sub I, 2(ii)*, first and second paragraphs, Supplementary Supervision Directive.

<sup>102</sup> It would have been desirable to leave the choice of the calculation method to the financial conglomerate in order to give companies more flexibility.

<sup>103</sup> See Annex I, second and third paragraphs, and Annex I, *sub II*, Method 4, Supplementary Supervision Directive.

<sup>104</sup> See Annex I, *sub II*, Method 1(i) and (ii) and third paragraph, Supplementary Supervision Directive.

<sup>105</sup> *SCA* shall mean the supplementary capital adequacy, that is, the surplus or deficit of the group-wide capital; *OF* shall mean own funds; and *S* shall mean the solvency requirements of a financial sector.

<sup>106</sup> The elements eligible are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub II*, Method 2(i), Supplementary Supervision Directive.

<sup>107</sup> The solvency requirements shall be calculated in accordance with the relevant sectoral rules, Annex I, *sub II*, Method 2(ii), Supplementary Supervision Directive. The calculation of own funds and solvency requirement shall take account of the proportional share held by a parent undertaking in a subsidiary or by an undertaking that holds a participation in another entity of the group. *Proportional share* means the proportion of the subscribed capital that is held, directly or indirectly, by that undertaking. Art. 6(4), second subparagraph, and Annex I, *sub II*, Method 2, third paragraph, Supplementary Supervision Directive. In the case of nonregulated entities, a notional solvency requirement shall be calculated. Annex I, *sub II*, Method 2, third paragraph, Supplementary Supervision Directive. See *supra* note 99.

<sup>108</sup> Although the wording in this point is not very clear, “participations in other entities of the group” means any participation that is held within the group, for example, participations of the parent in its subsidiaries or cross-participations of the subsidiaries. See Joint Forum Report, *Capital Adequacy Principles Paper*, at 14, *sub* no. 20.

<sup>109</sup> *SCA* shall mean the supplementary capital adequacy, that is, the surplus or deficit of the group-wide capital; *OF* shall mean own funds; *S* shall mean the solvency requirements of an entity of the group; and *BV* shall mean the book value of a participation.

<sup>110</sup> The elements eligible are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub II*, Method 3(i), Supplementary Supervision Directive.

<sup>111</sup> The calculation of own funds and solvency requirements shall take account of the proportional share held by a parent undertaking in a subsidiary

or by an undertaking that holds a participation in another entity of the group. *Proportional share* means the proportion of the subscribed capital that is held, directly or indirectly, by that undertaking. Art. 6(4), second subparagraph, and Annex I, *sub II*, Method 3(ii), Supplementary Supervision Directive. When evaluating the elements eligible for the calculation of supplementary capital adequacy requirements, participations may be valued by the equity method in accordance with the options set out in Art. 59(2)(b), Annual Accounts Directive. Annex I, *sub II*, Method 3, third paragraph, Supplementary Supervision Directive. In the case of nonregulated entities, a notional solvency requirement shall be calculated. Annex I, *sub II*, Method 3, third paragraph, Supplementary Supervision Directive.

<sup>112</sup> *SCA* shall mean the supplementary capital adequacy, that is, the surplus or deficit of the group-wide capital; *OF* shall mean the own funds of the parent on the basis of the single account; *S* shall mean the solvency requirements; and *BV* shall mean the book value of the parent's participation.

<sup>113</sup> See Joint Forum Report, *Capital Adequacy Principles*, at 21 and 26, Annexes 1 and 2.

<sup>114</sup> Art. 6(2), Supplementary Supervision Directive.

<sup>115</sup> See Michael Gruson, "Foreign Banks and the Financial Holding Company," [hereinafter Gruson, "Foreign Banks and the Financial Holding Company"], § 10.07[1] in Michael Gruson and Ralph Reisner, eds., *Regulation of Foreign Banks*, Vol. 1 (4th ed., 2003); Jeffrey D. Berman, Arthur S. Long, and Tomer Seifan, "U.S. Law Conditions Applicable to Foreign Bank Acquisitions of U.S. Banking Institutions," § 3.06[2] in Michael Gruson and Ralph Reisner, eds., *Regulation of Foreign Banks*, Vol. 1 (4th ed., 2003).

<sup>116</sup> Arts. 7(1) and 8(1), in connection with Annex II, Supplementary Supervision Directive.

<sup>117</sup> The Joint Forum Report, *Intra-Group Transactions and Exposure Principles*, at 134, *sub no.* 12. See also Tripartite Report, at 21, *sub no.* 55.

<sup>118</sup> Tripartite Report, at 18, *sub no.* 47.

<sup>119</sup> Tripartite Report, at 19, *sub no.* 50; see Joint Forum Report, *Intra-Group Transactions and Exposure Principles*, at 131, *sub no.* 4 for an enumeration of types of intra-group transactions and exposures.

<sup>120</sup> Art. 2(18), Supplementary Supervision Directive.

<sup>121</sup> Art. 2(18), Supplementary Supervision Directive. "Close link" is defined as a situation in which two or more natural or legal persons are linked by (1) a participation (20 percent of voting rights or capital), (2) control (parent-subsidiary relationship), (3) a similar relationship between any natural or

legal person and an undertaking, or (4) each being in a control relationship to the same third person (common control). Art. 2(13), Supplementary Supervision Directive. It is difficult to imagine cases in which an undertaking in a group has a close link to another undertaking by means of a participation or control but the other undertaking is not a member of the group. However, the link with a natural person and the link created through permanent control relationships by two natural or legal persons to a third person does not create a group relationship.

<sup>122</sup> See Art. 2(18) and Art. 8(1) and (2), Supplementary Supervision Directive, referring generally to regulated entities.

<sup>123</sup> Art. 8(3), Supplementary Supervision Directive.

<sup>124</sup> Sections 23A and 23B, Federal Reserve Act, 12 U.S.C. § 371c and 371c-1 (2000). See Robert E. Mannion and Lisa R. Chavarria, “Transactions Between Banks and Affiliated Enterprises” [hereinafter Mannion, “Transactions with Affiliates”], ch. 12 in Michael Gruson and Ralph Reisner, eds., *Regulation of Foreign Banks*, Vol. 1 (4th ed., 2003); Gruson, “Foreign Banks and the Financial Holding Company,” § 10.07[4].

<sup>125</sup> Art. 2(18), Supplementary Supervision Directive. See also Art. 55a, first subparagraph, Banking Directive, added by Art. 29(9), Supplementary Supervision Directive (transactions between a credit institution and its mixed-activity holding company).

<sup>126</sup> Defined in Art. 2(19), Supplementary Supervision Directive.

<sup>127</sup> The Joint Forum Report, *Risk Concentrations Principles*, at 141–46, *sub* nos. 4, 8–10, 11, 22, and 23.

<sup>128</sup> Art. 2(19), Supplementary Supervision Directive.

<sup>129</sup> Art. 7(3), Supplementary Supervision Directive.

<sup>130</sup> Art. 9(1), (2), (3), and (5), Supplementary Supervision Directive.

<sup>131</sup> Art. 9(4), Supplementary Supervision Directive.

<sup>132</sup> Art. 7(2), second subparagraph, and Art. 8(2), in connection with Annex II, Supplementary Supervision Directive.

<sup>133</sup> Art. 7(2) and Art. 8(2), second subparagraph, Supplementary Supervision Directive.

<sup>134</sup> Art. 7(2), second subparagraph, and Art. 8(2), third subparagraph, Supplementary Supervision Directive.

<sup>135</sup> Annex II, first paragraph, Supplementary Supervision Directive, referring to the reporting provision of Art. 7(2) and Art. 8(2), Supplementary Supervision Directive.

<sup>136</sup> Art. 7(4) and Art. 8(4), Supplementary Supervision Directive.

<sup>137</sup> Art. 13, Supplementary Supervision Directive.

<sup>138</sup> *See* recital clause No. (8), Supplementary Supervision Directive.

<sup>139</sup> Art. 28(4), Supplementary Supervision Directive, amending the Insurance Group Directive by adding Art. 10b; Art. 29(8), Supplementary Supervision Directive, amending the Banking Directive by adding Art. 54a. *See* Art. 6, Banking Directive, establishing management qualifications for managers of credit institutions.

<sup>140</sup> Arts. 10–17, Supplementary Supervision Directive.

<sup>141</sup> 2001 Explanatory Memorandum, at 7, *sub 2* (Arts. 7–13).

<sup>142</sup> Art. 10(1), Supplementary Supervision Directive.

<sup>143</sup> Art. 10(2) and (3), Supplementary Supervision Directive.

<sup>144</sup> *See* Art. 10(2)(b)(ii), second subparagraph, Supplementary Supervision Directive.

<sup>145</sup> Art. 11(1), Supplementary Supervision Directive.

<sup>146</sup> Art. 11(3), Supplementary Supervision Directive.

<sup>147</sup> Art. 12(1), Supplementary Supervision Directive.

<sup>148</sup> Art. 11(1), second subparagraph, Supplementary Supervision Directive.

<sup>149</sup> Art. 12(1), Supplementary Supervision Directive.

<sup>150</sup> Art. 12(2), Supplementary Supervision Directive.

<sup>151</sup> Art. 15, Supplementary Supervision Directive.

<sup>152</sup> *See* Art. 5(3), Supplementary Supervision Directive. Unlike the general approach applied in the United States under the U.S. Bank Holding Company Act of 1956, the Supplementary Supervision Directive does not regulate non-EU holding companies that control EU-regulated entities.

<sup>153</sup> Art. 5(3) and Art. 18, Supplementary Supervision Directive. *See* 2001 Explanatory Memorandum, at 7, *sub 2*, Art. 14.

<sup>154</sup> Art. 18(1), Supplementary Supervision Directive.

<sup>155</sup> The Financial Conglomerates Committee established under Art. 21, Supplementary Supervision Directive assists the EU Commission. It may give

general guidance as to whether the supplementary supervision arrangements in third countries are likely to achieve the objectives of the Supplementary Supervision Directive, in relation to the regulated entities in a financial conglomerate, the head of which has its head office outside the EU. Art. 21(5), Supplementary Supervision Directive.

<sup>156</sup> Art. 18(1), Supplementary Supervision Directive.

<sup>157</sup> See 12 C.F.R. § 225.92(e)(1) and (2) (2004) (Regulation Y) (election by foreign bank to become financial holding company); 12 C.F.R. § 211.24(c)(1)(i)(A) (2003) (Regulation K) (establishment of U.S. office by foreign bank); 12 C.F.R. § 225.13(a)(4) (2004) (Regulation Y) (acquisition of U.S. bank by foreign bank).

<sup>158</sup> Art. 18(2), Supplementary Supervision Directive. “Analogy” means “similarity in some respects between things that are otherwise dissimilar.” *American Heritage Dictionary* (4th ed., 2000). In the context of the Supplementary Supervision Directive, this presumably means “to the extent possible.”

<sup>159</sup> Art. 18(3), Supplementary Supervision Directive. According to Art. 18(3), second sentence, Supplementary Supervision Directive, those methods must be agreed on by the coordinator, after consultation with the other relevant competent authorities.

<sup>160</sup> Art. 18(3), ultimate sentence, Supplementary Supervision Directive.

<sup>161</sup> The BHCA applies directly to such foreign banks.

<sup>162</sup> Section 8(a), International Banking Act of 1978, 12 U.S.C. § 3106(a) (2000).

<sup>163</sup> Art. 19, Supplementary Supervision Directive makes Art. 25(1) and (2), Banking Directive applicable *mutatis mutandis* to the negotiation of such agreements.

<sup>164</sup> Art. 19(1), Supplementary Supervision Directive, in connection with Art. 25(1), Banking Directive.

<sup>165</sup> Art. 18, Supplementary Supervision Directive. If an EU-authorized credit institution is a subsidiary of a non-EU credit institution or financial institution, the competent authorities must verify whether the EU-authorized credit institution is subject to *consolidated supervision* by the home country of the non-EU parent that is equivalent to that required by the Banking Directive. Art. 56a, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive. The question whether an EU-authorized credit institution with a U.S. parent is subject to equivalent U.S. consolidated



supervision is discussed in Gruson, “Consolidated and Supplementary Supervision,” at 259–261.

<sup>166</sup> GLBA: Pub. L. No. 106-102, 106th Cong., 1st Sess. (1999), 113 Stat. 1338–4481 (1999). BHCA: 12 U.S.C. §§ 1841–1850 (2000).

<sup>167</sup> See Gruson, “Foreign Banks and the Financial Holding Company,” § 10.07[1].

<sup>168</sup> See Gruson, “Foreign Banks and the Financial Holding Company,” § 10.02[7][c]; Joyce M. Hansen, Ivan J. Hurwitz, and Diane L. Virzera, “Capital Regulation and Supervision of International Banking Organizations,” in Michael Gruson and Ralph Reisner, eds., *Regulation of Foreign Banks*, Vol. 1 (4th ed., 2003) [hereinafter Hansen, “Capital Regulations”], § 4.03[5][b].

<sup>169</sup> See Gruson, “Foreign Banks and the Financial Holding Company,” § 10.02[7][b].

<sup>170</sup> This follows from § 5(c)(3), BHCA, 12 U.S.C. § 1844(c)(3) (2000), which prohibits the Board from prescribing capital requirements on functionally regulated subsidiaries of a BHC (not functionally regulated BHCs). See Hansen, “Capital Regulations,” § 4.03[5][b].

<sup>171</sup> See Gruson, “Foreign Banks and the Financial Holding Company,” § 10.02[7][d]; Hansen, “Capital Regulations,” § 4.03[5][b].

<sup>172</sup> 12 U.S.C. §§ 371c and 371c-1 (member banks); 12 U.S.C. § 1828(j) (state nonmember banks); 12 U.S.C. § 1468(a) (federally insured savings associations) (2000).

<sup>173</sup> For a discussion of affiliates, see Mannion, “Transactions with Affiliates,” 12.02[3][a]. For these purposes, a foreign bank controlling a U.S. bank and the foreign bank’s foreign and domestic subsidiaries would be affiliates of the U.S. bank. *Id.* Sections 23A and 23B, Federal Reserve Act also apply to U.S. branches and agencies of foreign banks. See Gruson, “Foreign Banks and the Financial Holding Company,” § 10.07[4][d].

<sup>174</sup> A “controlled insurer” is an authorized insurer controlled directly or indirectly by a holding company. Section 1501(b)(4), New York Insurance Law (McKinney, 2000).

<sup>175</sup> “Holding company system” is a holding company together with its controlled insurers and controlled persons. Section 1501(6), in connection with (1)–(5), New York Insurance Law.

<sup>176</sup> Section 1505(a), New York Insurance Law.

<sup>177</sup> Section 1505(c), New York Insurance Law. *See* § 80-1.5(a) and (b), New York Codes, Rules, and Regulations, title 11, pt. 75, ch. IV.

<sup>178</sup> Section 1505(d), New York Insurance Law. *See* § 80-1.5(c), New York Codes, Rules, and Regulations, title 11, pt. 75, ch. IV.

<sup>179</sup> Section 1505(b), New York Insurance Law.

<sup>180</sup> § 80-1.4(a), New York Codes, Rules and Regulations, title 11, pt. 75, ch. IV.

<sup>181</sup> However, a foreign life insurer that is authorized to do business in New York and is controlled by a person not authorized to do insurance business in New York shall be deemed under certain conditions a domestic insurer. Section 1501(d), New York Insurance Law.

<sup>182</sup> *But see* 17 C.F.R. § 240.17h-1T(2) (2004) and 2T. *See* Form 17-H, Fed. Sec. L. (CCH), § 33,347.

<sup>183</sup> Hansen, “Capital Regulations,” § 4.03[5][b]; Board, SR Letter No. 00-13 (UP) (Aug. 15, 2000) [hereinafter Supervision Letter].

<sup>184</sup> Hansen, “Capital Regulations,” § 4.03[5][b]; Supervision Letter.

<sup>185</sup> SEC Release No. 34-49830, 82 SEC Docket 3515, 69 Fed. Reg. 34,428 (June 21, 2004) (Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities) [hereinafter CSE Release]. *See* proposed rule, SEC Release No. 34-48690, 81 SEC Docket 1208, 68 Fed. Reg. 62,872 (Nov. 6, 2003) [hereinafter CSE Proposed Release].

<sup>186</sup> CSE Release, 69 Fed. Reg. at 34,429; CSE Proposed Release, 68 Fed. Reg. at 62,874.

<sup>187</sup> *See* CSE Release, 69 Fed. Reg. at 34,430; *see also* 69 Fed. Reg. at 34,439 and 34,440–45. *See* new rule § 240.15c3-1e(a)(1)(viii) and (a)(2) (Appendix E to 17 C.F.R. § 240.15c3-1) and new rule § 240.15c3-1g (a), (b)(1) and (c) (Appendix G to 17 C.F.R. § 240.15c3-1).

<sup>188</sup> *See* CSE Release, 69 Fed. Reg. at 34,430; *see also* 69 Fed. Reg. at 34,439–41 and 34,445. “Ultimate holding company that has a principal regulator” is defined as an FHC including a foreign bank that has elected to be an FHC (new rule § 240.15c3-1(13)(ii)(A)), or an entity that the SEC determines to be an ultimate holding company that has a principal regulator if that person is subject to consolidated, comprehensive supervision and meets certain other conditions (new rule § 240.15c3-1(13)(ii)(B)). *See* CSE Release, 69 Fed. Reg. at 34,432. The more limited undertakings that a broker-dealer must submit if its ultimate holding company has a principal regulator are set forth in new rules § 240.15c3-1e(a)(1)(ix) and (a)(3) (Appendix E to 17

C.F.R. § 240.15c3-1). New rule § 240.15c3-1g(b)(2)(i)(B) (Appendix G to 17 C.F.R. § 240.15c3-1) allows an ultimate holding company that has a principal regulator to submit the capital measurement computed in accordance with the Basel Capital Standards as reported to its principal regulator.

<sup>189</sup> “Entity that has a principal regulator” is defined in new rule § 240.15c3-1(a)(13)(i) and includes, among other entities, an insured depository institution as defined in § 3(c)(2), Federal Deposit Insurance Act, 12 U.S.C. § 1813(c)(2) (2000); an insurance company licensed by a state insurance regulator; a foreign bank, as defined in § 1(b)(7), International Banking Act of 1978, 12 U.S.C. § 3101(7)(2000) that has its headquarters in a jurisdiction for which any foreign bank has been approved by the Board of Governors of the Federal Reserve System to conduct business pursuant to the standards set forth in 12 C.F.R. § 211.24(c) (2004), provided such foreign bank represents to the SEC that it is subject to the same supervisory regime as the foreign bank previously approved by the Board of Governors of the Federal Reserve System. *See* CSE Release, 69 Fed. Reg. at 34,431.

<sup>190</sup> *See* CSE Release, 69 Fed. Reg. at 34,430–34,439; CSE Proposed Release, 68 Fed. Reg. at 62,872; rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2004) and new rule § 240.15c3-1(a)(7), in conjunction with Appendix E to 17 C.F.R. § 240.15c3-1 (§ 240.15c3-1e).

<sup>191</sup> Section 17, Exchange Act, 15 U.S.C. § 78q (2000).

<sup>192</sup> SEC Release No. 34-49831, 82 SEC Docket 3578, 69 Fed. Reg. 34,472 (June 21, 2004) (Supervised Investment Bank Holding Companies) [hereinafter SIBHC Release]. *See* proposed rule SEC Release No. 34-48694, 81 SEC Docket 1262, 68 Fed. Reg. 62,910 (Nov. 6, 2003) [hereinafter SIBHC Proposed Release].

<sup>193</sup> *See* new rules § 240.17i-2 (notice of intention to be supervised by the SEC as SIBHC) and § 240.17i-3 (withdrawal from supervision by the SEC as an SIBHC).

<sup>194</sup> SIBHC Release, 69 Fed. Reg. at 34,473; SIBH Proposed Release, 68 Fed. Reg. at 62,911.

<sup>195</sup> Section 17(i)(5)(A), Exchange Act, 15 U.S.C. § 78q(i)(5)(A) (2000).

<sup>196</sup> Section 17(i)(5)(F), Exchange Act, 15 U.S.C. § 78q(i)(5)(7) (2000). *See* new rule § 240.17i-1(a).

<sup>197</sup> 15 U.S.C. § 78q(i)(1)(A) (2000).

<sup>198</sup> Section 17(i)(1)(A)(i)–(iii), Exchange Act, 15 U.S.C. § 78q(i)(1)(A)(i)–(iii) (2000). *See* § 8(a), International Banking Act of 1978, 12 U.S.C.

§ 3106(a) (2000) (foreign banks); § 25A, Federal Reserve Act, 12 U.S.C. § 611 *et seq.* (2000) (Edge Act corporations).

<sup>199</sup> New rule § 240.17i-2(a).

<sup>200</sup> New rule § 240.17i-4, referring to 17 C.F.R. § 240.15c3-4 (2004). *See* SIBHC Release, 69 Fed. Reg. at 34,477.

<sup>201</sup> 15 U.S.C. § 78q(i)(3)(A) (2000).

<sup>202</sup> These requirements of record creation and maintenance and access to records are set forth in new rule § 240.17i-5. New rule § 240.17i-6 contains reporting requirements.

<sup>203</sup> New rule § 240.17i-7. *See* SIBHC Release, 69 Fed. Reg. at 34,480-85.

<sup>204</sup> SIBHC Release, 69 Fed. Reg. at 34,481.

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SAMUEL MUNZELE MAIMBO

Since October 2001, there has been a plethora of new laws, regulations, recommendations, and best practice statements on the regulation and supervision of informal remittance systems. The text of most of these initiatives has been prepared in the context of prevailing anti-money laundering and terrorist financing concerns and thus contains provisions for the licensing or registration of remittance service providers, customer identification, suspicious transactions reporting, and record keeping.

At the same time, there is growing recognition that in and of themselves, the emerging regulations are an insufficient tool for addressing the phenomenon of informal remittance systems in both developed and developing countries. Recent research draws attention to the legitimate economic reasons for the existence of these systems. The absence of formal financial systems in countries such as Afghanistan, and even the absence of government structures in Somalia, for example, leave migrant workers with little option but to resort to alternative means of supporting their family and relatives. In the wake of the dual perspectives on the benefits and risks of informal remittance systems, the challenge for the development community, regulators, and law enforcement agencies is to identify a way in which to design, develop, and implement more effective regulatory and supervisory regimes that deal with the equally legitimate money laundering and terrorist financing concerns while at the same time facilitating and enhancing the development impact of informal remittances.

This chapter will review regulatory and supervisory economic literature on informal remittance systems and discuss the emerging differences in approach to dealing with this phenomenon. It gives examples of the different approaches, considers the rationale for

them, and concludes by contending that a synthesis of the four approaches discussed is essential for the effective regulation and supervision of informal remittance systems.

### Informal Remittance Systems

There are many terms used to describe informal remittance systems, including “alternative remittance systems,” “underground banking,” “ethnic banking,” and “informal value transfer system.” Geographically, the terms used to describe informal remittance systems include *fei-ch’ien* (China), *hundi* (Pakistan, Bangladesh), *hawala* (India and Middle East), *padala* (Philippines), *hui kuan* (Hong Kong), and *phei kwan* (Thailand).

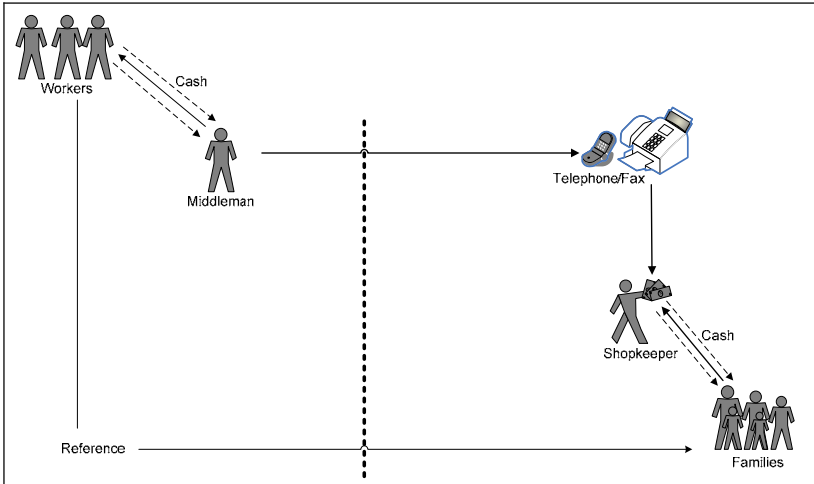
Despite the differences in terminology, the operational mechanisms of the various systems are fundamentally the same. For a basic informal remittance transaction to take place there needs to be a remitting party, two remittance service providers, and a recipient (see Figure 1). When the remitting party—for example, a Somali migrant worker in Italy—wants to send money to Mogadishu, he makes payment in euros or another convertible currency to a remittance agent or middleman in Rome. The service provider contacts a partner service provider counterparty (who might be a shopkeeper in the receiving country), who arranges payment in local (or other) currency to the remitter’s family or other beneficiary on the production of a pre-agreed reference.

As a form of identification for the transaction, the agent in the remitting country provides the remitter a code or reference that must be passed onto to his designated beneficiary for presentation to the agent in the recipient country (increasingly, a passport or national identification card is used by beneficiaries).

Once the funds have been paid to the recipient, the agent in the remitting country is indebted to the agent in the recipient country. The principals to the initial transaction do not play any role in subsequent clearing and balancing of this position. The agents can settle their positions in various ways, including simple transactions going in the opposite direction, cash deliveries, and settlement by checks into the relevant accounts. Their positions can also be transferred to other in-

termediaries. These other entities can assume and consolidate the initial positions and settle at wholesale or multilateral levels, also by various means.<sup>1</sup>

**Figure 1. The Basic Informal Remittance Transaction**



Highly trust-based, informal remittance systems have a long history of being reliable, inexpensive, speedy, accessible, and a convenient way of transferring funds in Asia, where they are thought to have originated, and many other parts of the world following waves of immigration, using minimal or no documentary requirements. The element of trust is a defining characteristic of most informal remittance systems. Trust has ensured that rarely, if ever, do customers lose their money. Informal dispute resolution processes among service providers have also made it an efficient payments system that attracted little interest or attention by regulators in developed countries until recently.

Unfortunately, the system's success—speedy transactions with minimal or no documentation—has also been its undoing. The anonymity that is possible with transactions of this kind has long raised concern in the law enforcement community, in general. In some countries such as India, governments have been so concerned about the command abuse of these systems as to ban them completely. Con-



cerned about the evasion of currency controls, developing countries, in particular, have long been worried about informal remittance systems, but only worries about terrorist finance brought it to international regulatory focus after the September 11, 2001 terrorist attacks in New York and Washington.

Once journalists and others had made putative connections between the financing of terrorism and informal remittance systems, it was inevitable that calls for more effective regulatory and supervisory frameworks would follow.

### **Emerging Regulatory and Supervisory Strategies**

The literature on regulating and supervising informal remittance systems is still in its infancy, and any categorization of that literature at this stage is necessarily for analytical purposes only. Practice is yet to confirm if this categorization is indeed a fair reflection of international and domestic experience. However, the more detailed analytical research must start somewhere.

### **Legal and Prudential Regulation Strategy**

In response to the concerns of linkages between terrorism and informal remittance systems spurred on by the events of September 11, 2001, the Financial Action Task Force (FATF) issued eight special recommendations aimed at combating terrorist financing, including one specifically addressing informal remittance systems. In Special Recommendation VI (SR VI), the FATF called on countries to either license or register informal remittance businesses and to subject them to all FATF recommendations that apply to banks and nonbanks.

According to SR VI—Alternative Remittance,

[e]ach country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and nonbank financial institutions. Each country should ensure that per-

sons or legal entities that carry out this service illegally are subject to administrative, civil, or criminal sanctions.<sup>2</sup>

Arguing that money or value transfer systems had shown themselves vulnerable to misuse for money laundering and terrorist financing purposes, the FATF issued SR VI with the objective of increasing the transparency of payment flows by recommending that jurisdictions impose consistent anti-money laundering and counter-terrorist financing measures on all forms of money/value transfer systems. Financial regulators began the process of reexamining existing regulations, and in some cases, designing, developing, and implementing new financial regulations.

In June 2003, the FATF issued a Best Practices Paper for combating the abuse of alternative remittance systems in which it adopted a broad definition of transfer systems by adopting the term “money or value transfer service” (MVT service), which refers to “a financial service that accepts cash, checks, other monetary instruments or other stores of value in one location and pays a corresponding sum in cash or other form to a beneficiary in another location by means of a communication, message, transfer, or through a clearing network to which the MVT service belongs. Transactions performed by such services can involve one or more intermediaries and a third party final payment.”<sup>3</sup>

In a deliberate attempt to be inclusive of the most possibilities, the paper also noted the following: that an MVT service may be provided by persons (natural or legal) formally through the regulated financial system or informally through entities that operate outside the regulated system; that in some jurisdictions, informal systems are frequently referred to as alternative remittance services or underground (or parallel) banking systems; and that often these systems have ties to particular geographic regions and are therefore described using a variety of specific terms, which include hawala, hundi, fei-chi’en, and the black market peso exchange.

The FATF further recommended that to maintain consistency with the obligations imposed on other financial institutions, jurisdictions should introduce transaction reporting in line with their current

reporting requirements for financial institutions. Specifically, it recommended that

[j]urisdictions may consider issuing specific guidance as to what may constitute a suspicious transaction to the MVT service industry. Some currently used indicators of suspicious financial activity, such as those found in the FATF's Guidance for Financial Institutions in Detecting Terrorist Financing, are likely to be relevant for money/value transfer service activity. However, particular activities and indicators that are unique to this sector should be further developed.

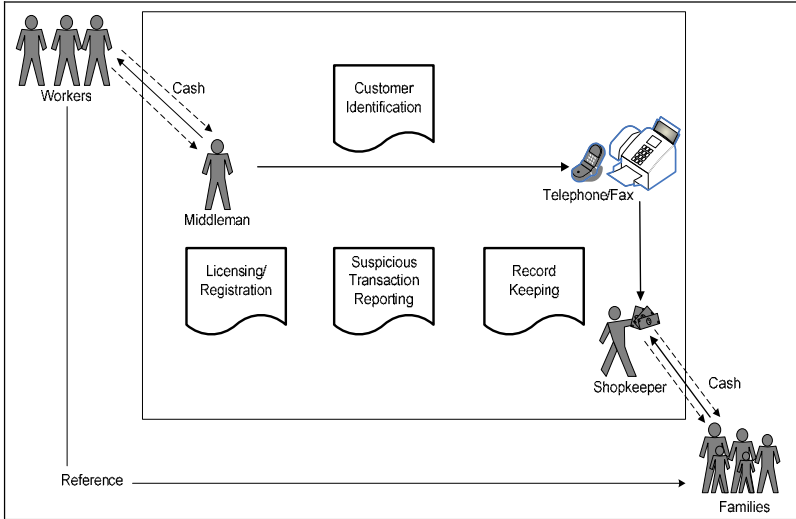
The second half of FATF's Special Recommendation VII on Wire Transfers should also be taken into account when developing guidance in this area. For example, operators that receive funds/value should ensure that the necessary originator information is included. The lack of complete originator information may be considered as a factor in assessing whether a transaction is suspicious and, as appropriate, whether it is thus required to be reported to the [Financial Intelligence Unit] or other competent authorities. If this information is not included, the operator should report suspicious activity to the local [Financial Intelligence Unit] or other competent authority if appropriate.<sup>4</sup>

The underlying rationale for recommending the regulatory instruments noted above is that licensing and registration will help isolate legal from illegal remittance service providers and that those who operate legally will report suspicious transactions, enabling regulators to report terrorist financing activities, and other financial abuses, to law enforcement agencies.

As Figure 2 indicates, the legal approach to regulating and supervising informal remittance systems seeks to superimpose existing formal financial sector regulatory and supervisory practices on an informal system. To its credit, the FATF has made it clear that in the application of its recommendations, supervisory agencies must be mindful of their own domestic circumstances. The objectives of the recommendations and best practices are to introduce a measure of transparency in the operation of these financial systems. Customer identification guidelines, licensing or registration requirements, suspicious transaction reporting procedures, and record keeping stan-

dards are all aimed at reducing the financial abuse of systems that, rightly used, can provide a valuable service to migrant workers.

**Figure 2. The Legal and Supervisory Approach**



This rationale begs the question: Can we target illegal acts perpetrated through informal remittance without affecting unduly or disrupting trade or harming legitimate enterprises of the numerous innocent customers who remit honest money back home to their family?

Regulating informal remittance systems, it has been argued, may not be a solution as it does not address the primary apprehensions and concerns regarding its use for terrorist financing and assisting money launderers in the countries where it is intended to be regulated. There is no guarantee that even after regulation, illegal transactions would not continue through other unlicensed operators. The legal approach may not even be practical as informal transfers involve cross-border transactions between two jurisdictions, and, while it may not be illegal in one country, it may be so in the other country, and this would be a bar on regulation.

Further, there is often a complex web of transactions in the settlement of informal remittance deals between the originating and re-

ipient countries unlike official bank to bank transactions, and such settlements may not be amenable to regulation in all the countries concerned. In view of these facts, some have argued that it may not be advisable to prescribe international standards for regulating and supervising remittance systems, and rather, what is more important is a sector-wide approach to the development of the financial sector as a whole.

### **Financial Sector Development Strategy**

In their study of informal remittance systems, Maimbo, El Qorchi, and Wilson<sup>5</sup> argued that the emerging legal approach to informal remittance systems needed to sufficiently take into account specific domestic circumstances. They cautioned against the application of the FATF Recommendations without due regard to specific domestic circumstances. Recognizing that developing international regulatory and supervisory standards for informal funds transfer systems is a complex process, they called on regulators to note the differences in the stages of national economic development in general, and the financial sector in particular.

Regulators, they argued, had to bear in mind that prescribing regulations alone would not ensure compliance. Regulations were not a panacea for possible abuse of the informal remittance system. Specifically, regulators needed to possess the appropriate supervisory capacity to enforce the regulations. Further, Maimbo, El Qorchi, and Wilson emphasized that regulators had to bear in mind that experience shows that restrictive methods will not drive out all businesses involved in unlicensed financial transfer activity from the market. The informal banking system could not be eliminated by means of criminal proceedings and prohibition orders. Policymakers acknowledge the existence of practical reasons, from the customer's point of view, to resort to these methods rather than formal banks for international payment purposes. As long as such reasons exist, informal remittance systems will continue to exist.

For purposes of long-term financial sector development, they therefore recommended that in the majority of countries, where informal remittance systems existed alongside a functioning conventional banking sector, informal remittance dealers be registered. In these systems, additional efforts should be made to improve the level

of transparency by bringing the informal remittance systems closer to the formal financial sector without altering their specific nature. Simultaneously, the regulatory response must address the weaknesses that may exist in the formal sector. The formal and informal financial systems benefit from their mutual deficiencies and each tends to expand when the condition of the other is impaired. High transaction costs, long delays in effecting money remittances, exchange controls, and overly bureaucratic policies and procedures for simple money transfers are major incentives for the existence of the informal financial system. To face the challenge, the formal sector had to tackle its deficiencies and enhance its competitiveness. In conflict-afflicted countries with no functioning banking system, imposing requirements beyond basic registration may not be feasible because of lack of supervisory capacity.

This strategy was not new. Buencamino and Gorbunov had earlier observed that over the years governments were introducing a number of incentive-based and mandatory measures to encourage migrants to remit more through formal channels.<sup>6</sup>

Commenting on the mandatory minimum remittance requirements introduced in Bangladesh, Republic of Korea, Pakistan, and the Philippines, they observed that mandatory measures were only successful where the government played an active role in the process by directly assisting local companies to win contracts abroad. In turn, the local company deposited all or a portion of the employees' earnings abroad in local banks.

Incentives rather than mandatory regulations have higher chances of success. Migrant foreign currency accounts and bands that are not subject to foreign exchange regulations and offering above-market interest rates have been successful in Bangladesh, India, Pakistan, and Vietnam. In other countries such as Egypt, Poland, and Turkey, premium exchange rates are used for conversion of foreign currency into local currency.

Yet this approach to encouraging a shift from informal to formal, they conclude, has had mixed results primarily because these instruments largely attract professional and higher-skilled categories of migrants who earn relatively high incomes and have funds for

investments—a category of employees who are usually a minority of migrant workers.

It has been argued, as noted by Buencamino and Gorbunov, that the best way to significantly reduce the volume of informal transactions is the liberation of the economy. Social and economic stability, a low rate of inflation, positive interest rates, a stable and realistic exchange rate, and reliable financial institutions are important elements in a migrant's decision to remit through the formal channels as opposed to informal remittance systems. Referring to the O'Neill study<sup>7</sup> of six major labor-exporting countries in North Africa and Europe, they make the case that a rise in the black market premium by 10 percent results in a decline in official remittances by 3 percent. Doing away with dual and parallel exchange markets, they contend, is an effective strategy for diverting remittances into formal channels.

### **Institutional/Payments Systems Strategy**

Buencamino and Gorbunov rightly argue that an effective strategy for attracting funds into the formal financial sector cannot be limited to macroeconomic and financial sector development strategy issues. Improving the ability of formal financial institutions to compete with the informal market is a requisite component.

Efficiency, costs, reliability, outreach, products offered, and convenience are critical factors that migrants consider in determining a preferred remittance channel. Unless viable formal sector options are available, exchange and interest rate-based incentives are inadequate motives for formal sector remittance usage.

They conclude that reducing entry barriers proves a convenient means through which to increase private sector participation in the sector; increase competition and, ultimately, the quality of formal sector remittance services increases. Banks and remittance companies have recently introduced new materials of settlement and delivery of funds, including door-to-door services, language translation offers, money transfer services to undocumented workers, and additional bank options for recipients to allow automated teller machine (ATM) withdrawals.

This approach recognizes that the choice of remittance channel is fundamentally a payment system issue. At its most basic level, a

payment system is merely an agreed-upon way to transfer value between buyers and sellers in a transaction. In developed economies, currency, checks, and some electronic means are used simultaneously.<sup>8</sup> In less developed economies, commodities and currency are dominant.

The key strategy here is to expand the distribution points for the payment system network—expanding bank/financial institution branches or at least money recipient points—by partnering with other banks, postal services, microfinance institutions, and money transfer and exchange agencies. Technology has facilitated this approach by increasing the capacity of banks to offer ATM services. Referring to a recent study, Buencamino and Gorbunov contend that by 2006, ATM transactions will likely be 11 percent market share in global remittances; it was 0.2 percent in 2002.<sup>9</sup> And critically, the introduction of ATM services in developing countries may lead to the emergence of a new generation of remittance companies competing with card-based products at a global level in order to benefit from economies of scale.

In an innovative study of the U.S.-Mexico Remittance Corridor, the World Bank adopted this approach to improving the regulatory and supervisory environment for remittances.<sup>10</sup> Having framed the study under the three operational stages of remittance transactions (Origination, System Operation, and Distribution), the study concluded with a set of policy lessons and recommendations that have been discussed during the preparation of the paper with the countries involved.

In the Origination phase, the study noted that Mexican migrants have had better access to formal mechanisms, mainly through banks. This has been a key factor for the integration of Mexican migrants into the formal financial sector. The use of the Mexican consular identification card as a tool to access financial services, combined with higher levels of financial education among migrants, have both also been key factors in facilitating an increased use of formal channels to remit funds.

At the intermediary stage (System Operation), increased competition, technology, and innovative products have created a true market for system operators and transaction facilitators. Finally, at the last stage (Distribution), the study observed that distribution networks



have expanded in urban and rural areas, streamlining remittance delivery and contributing to lower prices for remitters and, more important, reliable delivery of funds to the recipient, which is a critical factor in the decision-making process of the sender.

Further, in a country like Somalia, where there is no government and the regulatory and supervisory capacity is absent, the institutional approach has to include empowering the private remittance institutions with self-regulatory powers. Indeed, the Somali Remittance Association, with the aide of the United Nations Development Programme (UNDP) has already embarked on this path with the establishment of the Somali Financial Services Association on September 28, 2003.<sup>11</sup> The UNDP has been engaged with the Somali Remittance sector to ensure that the crucial flow of money remains open to Somalia despite the absence of a government and the closure of the largest remittance agency in November 2001.

### **Anthropological Approach**

An interesting but unexplored approach of regulating and supervising the informal remittance system is the anthropological dimension. Reading the economic literature to date leaves one to conclude the choice between formal and informal channels is primarily an economic one—with adequate financial incentives, migrants will choose to remit through a bank instead of the local informal remittance system service provider. This might not always be the case.

Monsutti, in his study of cooperation, remittances, and kinship among the Hazarus in Afghanistan, argues that economic funds transfers do not occur in isolation, but rather are embedded in social relations.<sup>12</sup> Funds transfers are both a means of survival and a way of structuring transnational Afghan society as well as a very efficient tool to reproduce social normalcy despite the war and dispersion of members of each domestic and solitary group.

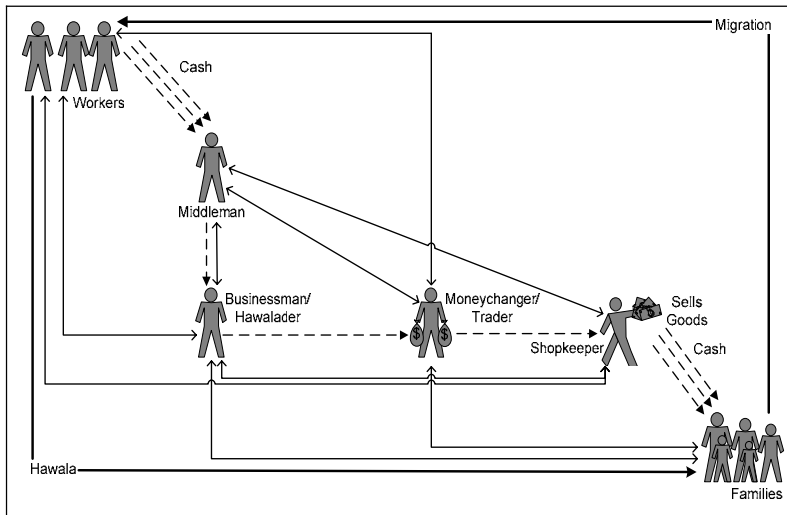
Much is written about the levels of trust associated with informal payment systems. But there is little in the deconstruction of this trust. Efforts to understand this trust in the economic literature are superficially attributed to kinship and ethnicity. In the anthropological literature, the sources of trust are not only examined in detail and better explained, but are also associated with the equally powerful

emotions of rivalry, competition, and jealousy within the same realm of kinship.

Monsutti, for example, draws a comparison between “multilateral kinship cross cousins” (sons of a brother and sister), who are the persons of choice for borrowing money, and “multilateral parallel cousins” (sons of two sisters), which seem to rarely be the basis for building a commercial partnership, with patrilateral kinships. The latter, he argues, are structurally opposed to friendship and, to some degree, to kinship and alliances. Though cooperative, the level of trust is not the same.

Cooperation and trust, he explains, do not automatically emerge from a given social tie. Rather, one has to consider the social constructs surrounding matriarchal and patriarchal relocations, friends, and external agents. And so it is with the remittance system (Figure 3). The channels of migration and of funds transfers include four types of actors: (1) close relatives among whom solidarity and conflict are possible but along predictable lines; (2) distant relatives and friends who represent the people of choice for lending money or becoming business partners; (3) people from the same circle, or same ethnic or social background, who may be linked by the informal remittance system but who may not be engaged in a close economic partnership; (4) people from the host society with whom it is often necessary to be in touch (smugglers, forgers, and middlemen, etc.).

In his study of the Hazarus, Monsutti finds that, besides its economic significance, the local remittance system has an even more important social dimension—it allows the reproduction of social ties despite insecurity and dispersion. The exchanges taking place through the circulation of people, documents, and money bring together religious, judicial, political, economic, and family ties. The exchanges do not only satisfy material needs, but also produce and reproduce social ties. The relationship between material ties and social ties is reciprocal. He concludes, “The hawala system, a complex set of solidarity and completion relationships, explains how Afghan society, despite war and migration, has not collapsed into a Hobbesian chaos.”

**Figure 3. Anthropological Strategy**

In the Mexican context, social relations play a significant role in facilitating informal remittance transactions. Hernandez-Coss observed the decision to use an informal remittance channel over a formal one was influenced by personal relations, notably the following:<sup>13</sup>

- Personal contacts are a key aspect of the informal remittance channels from Mexican migrants because they represent a personal social link back home as do Home Town Associations (HTA).
- The informal funds transfer (IFT) systems operating between Mexico and the United States are primarily an extension of the larger cross-border social connections between migrants and their home communities in Mexico.
- Unlike IFT systems in other parts of the world that developed as a result of facilitating trade—for example, the hawala system in the Middle East—the IFT systems between the United States and Mexico facilitate the movement of funds, as well as letters, food, and other nostalgic goods. Sometimes the channel through which funds are remitted informally involves the same contacts and people who facilitated the migration of the worker.

- Many of the HTAs are representative of a particular region of Mexico that has, over time, sent migrant workers into a particular U.S. city, where migrants have organized themselves into an expatriate community. Therefore, we observed “regional corridors” within the U.S.-Mexico corridor.
- The HTA represents a concerted effort to organize remittances in the United States for small-scale development projects in the home community in Mexico. According to Federation of Michoacan Clubs in Illinois, the personal and social link developed through the HTA gives migrants a way to stay involved in their hometowns, and, as a result, the HTAs have had some notable success stories.
- The Michoacanos that are in the United States are still very connected with their community in Mexico, and in their minds, there is the hope to return to Mexico one day. The immigrants raise money to build public services in their communities in Mexico. The main public services that they build are water pipes, collecting pipes, pantheons, churches, streets, and so forth. The funds for these building projects are normally transported to Mexico by hand when someone from the community goes to Mexico to visit the family.

Regulatory and supervisory efforts need to take into account the social relations between individual families and the broader social communities. Well-organized communities with clear objectives and money transfer mechanisms should be invited to discuss their regulatory and supervisory mechanisms and, if deemed adequate, invited to complement the efforts of an external regulatory agency.

## Conclusion

Insufficient theoretical and practical experience with formal and informal remittance regulation and supervision warrants an incentive-based regulatory approach rather than one based solely on direct external regulatory interventions.<sup>14</sup>

Now that the initial rush to regulate informal remittance systems, with practice preceding a comprehensive theoretical debate and empirical research, is being balanced by a broader assessment of the

regulatory implications, perhaps more effective strategies for dealing with the regulatory and supervisory challenges of informal remittance systems—the absence of transparent audit trails, difficulties in interpreting informal remittance records, and the practice of conducting remittance business as part of other cash-rich businesses—will emerge.

The regulatory community does not have an adequate understanding of these issues. There needs to be a concerted and systematic evaluation of the regulatory objectives and supervisory strategies, tools, and mechanisms applicable to informal remittance systems. Regulators need to consider the legal, macroeconomic, and institutional payment systems and an anthropological approach to regulating and supervising informal payment systems.

The Hernandez-Coss study on the remittance channel between the United States and Mexico is the best practice in this regard. Its recommendations cover the broad spectrum of the preferred combinations of policy actions. For example, three of the study's recommendations include the following:

- **Legal:** The role that IFT systems play in filling a vacuum of financial services to the underserved should be appreciated and imitated by formal channels. IFT systems, by registering and licensing, can then move closer to “formalization” and experience the benefits of operating in a transparent market.
- **Institutional Payment Systems:** “Cajas,” microfinance institutions, and the BANSEFI<sup>15</sup> network are important links in the chain for formal remittance systems to reach rural regions, and authorities should foster the development of these institutions. They act as a rural remittance distribution network that brings financial services to communities that have been disconnected from mainstream services.
- **Anthropological:** Formal channels would benefit from market strategies that consider the social nature of remittances for Mexican migrants, and adapt their products, services, and branches to these considerations. These market strategies should consider “the corridors within the corridor”: specific regions in the United

States where the remittances originate and those regions in Mexico where they are received.

Many central banks are making the effort. Often, the central banks with a large volume of remittance activities are the very same ones with limited resources to meet the challenge. In some jurisdictions, such as Afghanistan and Somalia, reforming the formal financial sector immediately after active conflict is difficult enough, and undertaking to regulate the informal sector under such circumstances is doubly daunting.

In Afghanistan, for example, the challenge of regulating an informal system with a long history of independence and self-regulation in an environment where incentives for compliance are weakened by weakness of the legal and judicial framework for the prosecution of financial crimes is self-evident. The challenge is further compounded by the complexity of investigating money laundering and terrorist financing crimes in a country with a significant economy and the emerging risk of a nexus of drug trafficking with terrorist/militant groups.

To these challenges, applying all four strategies discussed above—legal, financial sector development, institutional payments system, and anthropological—is the most sensible approach. The market's simplicity, cost-effectiveness, and convenience will ensure its survival for years to come. Informal remittance systems' cost-effectiveness and speed cannot, nor should they, be regulated away. Instead, their transparency should be enhanced through the creative application of regulatory and supervisory standards that minimize the risk of financial abuse.

## Notes

<sup>1</sup> For more details on informal remittance systems and how they work, including their economic and legal implications, see N. Passas, “Informal Value Transfer Systems and Criminal Organizations: A Study into So-Called Underground Banking Networks,” report commissioned by the Research and Documentation Center of the Ministry of Justice, Netherlands, 2000. S.M. Maimbo, M. El Qorchi, and J.W. Wilson, *Informal Funds Transfer Systems: An Analysis of the Informal Hawala System*, Joint IMF–World Bank Paper, Occasional Paper No. 222 (Washington: IMF, 2003). S.M. Maimbo, “The Money Exchange Dealers of Kabul: A Study of the Hawala System in Afghanistan,” World Bank Working Paper No. 13 (Washington: World Bank, 2003).

<sup>2</sup> FATF, Special Recommendations on Terrorist Financing, SR VI, October 2001, <http://www.fatf-gafi.org/dataoecd/8/17/34849466.pdf>.

<sup>3</sup> FATF, Combating the Abuse of Alternative Remittance Systems, International Best Practices, June 2003, <http://www.fatf-gafi.org/dataoecd/39/17/34033713.pdf>.

<sup>4</sup> *Id.* Para. 21.

<sup>5</sup> *Supra* note 1.

<sup>6</sup> L. Buencamino and S. Gorbunov, “Informal Money Transfer Systems: Opportunities and Challenges for Development Finance,” November 2002, <http://www.un.org/esa/esa02dp26.pdf>.

<sup>7</sup> A. O’Neill, “Emigrant Remittances: Policies to Increase Inflows and Maximize Benefits,” 9(1) *Indian Journal of Global Studies* (Fall 2001).

<sup>8</sup> David B. Humphrey, *Payment Systems: Principles, Practice, and Improvements*, Technical Paper 260 (Washington: World Bank, 1995).

<sup>9</sup> Buencamino and Gorbunov, *supra* note 6, at 10.

<sup>10</sup> World Bank, “The U.S.-Mexico Remittance Corridor: Lessons on Shifting from Informal to Formal Transfer Systems,” February 2005, [http://www.microfinancegateway.org/files/23835\\_file\\_31671.pdf](http://www.microfinancegateway.org/files/23835_file_31671.pdf).

<sup>11</sup> KPMG, “Feasibility Study on Financial Services in Somalia” (Nairobi: UNDP, 2003).

<sup>12</sup> A. Monsutti, “Cooperation, Remittances and Kinship among the Hazarus: War, Migration and the Economy of Afghanistan,” 37(2) *Iranian Studies* (June 2004).

<sup>13</sup> R. Hernandez-Coss, “Lessons from the U.S.-Mexico Remittances Corridor on Shifting from Informal to Formal Transfer System” (Washington: World Bank, 2004).

<sup>14</sup> This conclusion is explored in greater detail in S.M. Maimbo and N. Passas, “The Regulation and Supervision of Informal Remittance Systems,” 15(1) *Small Enterprise Development* (2001), at 53–61.

<sup>15</sup> Banco del Ahorro Nacional y Servicios Financieros, S.N.C.



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## **V. MONEY LAUNDERING AND FINANCING OF TERRORISM**

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JEFF BREINHOLT

In seeking to suppress the financing of terrorism, central banks face some of the same challenges as their law enforcement counterparts: the act of transferring funds, by itself, is neither evil nor something that should be discouraged. As we know, dirty money can be applied to legitimate purposes, a process that has come to be known as “money laundering.” Similarly, clean money can be applied toward nefarious conduct, as in terrorist financing. In either case, the financial trail appears at first glance to be indistinguishable from legitimate commercial transactions. Rarely does a financial record, by itself, look suspicious.

To effectively ferret out money laundering or terrorist financing, central bankers must do what fraud investigators seek to do: look beneath the surface to uncover the nature of particular transactions to determine whether they are legitimate or properly motivated. In this sense, the role of the central banker in countering terrorist financing is much like the criminal investigator, involving the same skills and operational issues. Like their police counterparts, central bankers are bound by their countries’ legal tradition: they must operate under the rule of law. No one suggests otherwise.

To complicate matters, the applicable law varies from nation to nation. In terms of what central bankers can collect, review, and disclose to law enforcement, what may be legal in Italy may be prohibited in Japan. This presents a challenge to establishing a worldwide solution to what is a global problem: no matter how much consensus exists on the existence and nature of the problem of terrorist financing, the specific means of combatting it will necessarily vary from country to country.

This chapter is premised on the notion that central banks can benefit from understanding the law enforcement challenges faced by countries, like the United States, that have tried to target their law enforcement resources at the unique problem of the white-collar terrorist. There is no intention to suggest that the American experience is universal, nor that it should be used as an all-purpose template; rather, the objectives are far more modest: offering some legal and historical insight from a law enforcement perspective. In this case, it is from the vantage of a financial prosecutor.

### **Why the United States?**

Although experts were studying terrorist financing for years, it only became a concerted global effort after September 11, 2001 (9/11). Countries like the United States, which now claim to be leading the war on terrorist financing, did not always take the problem as seriously as they should have done so. This is a historical fact.

In the 1980s, for example, while American officials were imploring other countries to cease providing physical haven to terrorist groups like the Abu Nidal Organization and Hizballah, a unique brand of international terrorist was operating in our midst. White-collar professionals—doctors, lawyers, bankers, academics, journalists—came to the United States to raise funds for violent organizations with which they were associated. During this era, some of the most lethal terrorist organizations operating in the world, like the Palestinian Liberation Organization (PLO) and the Irish Republican Army (IRA), raised a significant portion of their operating budgets in North America. Indeed, it may not be a stretch to say that the United States, Canada, and Western Europe were serving as *financial* staging grounds for worldwide political violence.

How did this happen? In the United States, it was due in part to our legal tradition. American law generally does not criminalize thoughts, speech, or status. Instead, the law typically requires some act, combined with some malevolent intent. There is no American crime of being a terrorist, thinking terrorist thoughts, or advocating terrorism. Persons here are not prosecuted for their speech or because of their associations.<sup>1</sup> Some people note that the United States Code defines the term “federal crime of terrorism.” However, this provision

merely provides a reference list of offenses that are considered to be terrorism.<sup>2</sup> The offenses include such acts as hijacking, assassination, hostage taking, using weapons of mass destruction, and the destruction of government buildings. To convict someone of these crimes, the U.S. prosecutor must prove that the defendant committed some particular prohibited act with the requisite malevolent intent. This was not an easy task where the terrorist was a financier, rather than front-line terrorist.

With this tradition, using American law enforcement to prevent acts of terrorism was a rather clumsy process. Even though our legal tradition recognizes the inchoate offenses of attempt and conspiracy, our police officers must wait until would-be terrorists show their hands and take an affirmative step in furtherance of their illegal plan in order to take a law enforcement action that will stand up in court. This is a dilemma that presents a thorny operational problem. It is risky to allow even a fledgling terrorist plot to proceed. Even if law enforcement could be inserted into the earliest stages of conspiratorial planning, the decision when to step in and disrupt the terrorist plot is rarely unanimous. Questions inevitably arise. Relevant officials vary on fundamental issues. Do we currently have enough evidence? Should we wait for the plot to go further to ensure that a jury will be more likely to believe that they actually intended to commit the terrorist act, while raising the risk that the plot will succeed? In every undercover operation undertaken by American law enforcement—organized crime, drug conspiracies, or public corruption stings—there is controversy within the police ranks about when to “take it down” and make arrests. With terrorism, these challenges are exacerbated, since the stakes are so much higher. The risk of letting the terrorist planning we know about go further can literally be a matter of life and death.

This problem is made even more acute when the individual participants are not all involved in the *violent* aspects of the plot. If the plot involves white-collar professionals who themselves do not handle weaponry, they will generally not be in the same room as their bomb-throwing colleagues. Their role will be more subtle, like the raising and transfer of funds, and will often be accomplished from afar rather than through face-to-face meetings. These white-collar types nevertheless play a pivotal role in the plot logistics.

Fortunately, the world now recognizes that white-collar terrorists should not escape scrutiny, and that effective counterterrorism efforts must necessarily focus on every participant in the plot, from the bomb-throwers to the financial facilitators. This is the main reason central banks are now involved in counterterrorism.

The world's central banks now find themselves focusing on the same problem that has plagued those of us within American law enforcement: how to discover and deal with the white-collar terrorist, in accordance with the unique legal tradition of their countries. Faced with this common problem, central banks share our operational challenges. They are being asked to monitor the flow of funds that are not clearly marked as derived from dirty sources or destined for nefarious applications. Like us, the world's central banks often do not have full access to information that will easily disclose the identity of the bomb-throwers. Instead, their information will be limited to more peripheral players at either end of financial transactions, for which financial institutions happen to maintain records. To meet this new challenge, it helps to understand some basic concepts and definitions.

### **What Is Terrorist Financing?**

Within American law enforcement, the term terrorist financing has traditionally referred to the act of knowingly providing something of value to persons and groups engaged in terrorist activity. This crime has been officially recognized within the United States since 1994, with the enactment of the first American “material support” crime.<sup>3</sup> Before then, such conduct could only be redressed through money laundering prosecutions.<sup>4</sup>

As a target of police action, terrorist financing is similar to money laundering, and plays a role in counterterrorism akin to money laundering in the war on drugs. “Money laundering” is the process whereby money that is the product of some specified unlawful activity is cleaned, its source disguised, and is placed inside the banking or other mainstream financial system. “Terrorist financing,” while it sometimes involves dirty money, differs in that its focus is on the application—rather than the illegal source—of funds. In terrorist financing, it does not matter whether the transmitted funds come from a legal or illegal source. Indeed, terrorist financing frequently involves funds that, prior to being remitted, are entirely clean and unconnected

to any illegal activity. A common example occurs when legitimate dollars are donated to charities that, sometimes to the chagrin of donors, are in reality fronts for terrorist organizations.

Meanwhile, tracking terrorists' financial transactions is more difficult than following the money trails of mainstream criminal groups because of the relatively small amounts of funds required for terrorist actions and the range of legitimate sources and uses of funds. While many organized crime groups are adept at concealing their wealth and cash flows for long periods of time, their involvement in the physical trade of illicit drugs, arms, and other commodities often exposes their revenues and expenditures connected to illegal dealings. In contrast, terrorist attacks are comparatively inexpensive. The financing of particular attacks is often overshadowed by the larger financial resources allocated for the group's political and social activities, making it more difficult to uncover the illicit nexus.

Within the United States, the enactment of the first American material support crime in 1994 was followed by additional legislative changes, starting with the 1996 enactment of the powerful "material support to designated terrorist organizations" crime, 18 U.S.C. § 2339B, and continuing to the recent changes enacted with the USA PATRIOT Act. Today, there are several different crimes, and many new investigative tools, available to U.S. law enforcement personnel involved in identifying and punishing the white-collar terrorist. Central banks might benefit from an understanding of how these tools work, if only to consider what might be done within the context of their own countries' laws. Before examining their specifics, it is important to step back and look at the American approach to counterterrorism as a law enforcement matter generally, since this involves something that is important to central banks: a legal tradition that is designed to protect individual liberties while facilitating commerce.

### **The American Law Enforcement Approach to Terrorism**

Although the United States has been fighting terrorism since President Thomas Jefferson dealt with the Barbary pirates in the eighteenth century, our treatment of terrorism as a law enforcement issue is a relatively modern development. This is partly due to the fact that, until the last quarter century, the United States was not the target



of choice of international terrorists. In fact, from the 1960s to the 1990s, most acts of terrorism against U.S. interests occurred abroad or in the air. Empirically, Americans who remained with their feet on U.S. soil could feel relatively safe from terrorist threats.

The evolution of the U.S. terrorism criminal statutes was driven by the establishment of principles of international law, generally through multilateral treaties negotiated under the auspices of the United Nations. These treaties include what are known as “extradite or prosecute” instruments, whereby signatory states are required to define certain terrorism-related crimes and the means of enforcing them.<sup>5</sup> They also include nonterrorism treaties that officially recognized customary international law concepts regarding the nations’ rights to assert criminal jurisdiction over persons located, and conduct occurring, outside of their boundaries.

The U.S. Constitution recognizes the inviolable right to free expression and free association, and the right to be free from deprivations of liberty or property without “due process of law.” As interpreted by American courts, persons in the United States cannot be prosecuted for their thoughts alone, nor can the United States criminalize conduct protected by the First Amendment. As a result, our criminal jurisprudence stresses definable acts, rather than thoughts or speech unattached to particular conduct.

Terrorism crimes are developed in the same manner as other law enforcement areas: policymakers determine what negative results should be prevented, and then craft criminal laws that take into account how such results are generally achieved. On occasion, acts that are criminalized are not ones that should necessarily be discouraged, if committed by persons not otherwise involved in the offensive result sought to be prevented. Ideally, laws are crafted to criminalize such conduct only when committed in particular circumstances.

### **The Narcotics Analogy**

The best illustration of this concept comes from the war on drugs. To combat the growing scourge of illicit drugs on urban streets, American police aggressively enforce the crimes of importing, distributing, and possessing certain controlled substances. From there,

criminologists determine how drug dealers typically operate and help draft new laws to criminalize that particular conduct.

Drug dealers, for example, cannot enjoy the proceeds of their crime unless they can find a way to spend it without drawing attention to themselves. To do this, they rely on financial institutions to store and transfer their illegal proceeds, and find ways to make their proceeds appear legitimately derived. Recognition of this phenomenon led to the creation of the crime of money laundering: engaging in financial transactions for the purpose of making dirty money appear clean.

Part of the U.S. anti-money laundering program involved establishing required reports that must be generated and provided to the Treasury Department upon the occurrence of an act that conforms with what is known about drug dealers' operations. For example, because illegal drugs are generally purchased with cash, drug dealers will typically make large cash deposits into their bank accounts. Since the 1980s, U.S. banks have been required to generate a report, known as a Currency Transaction Report (CTR), any time a customer deposits more than US\$10,000 in cash.<sup>6</sup>

Is this fair to the person in a legitimate cash business who happens to deposit cash in excess of US\$10,000? Note that the law merely requires the submission of a report. It does not mark the commission of a crime. The reporting requirement recognizes that there may be legitimate reasons to make large currency deposits. Persons who fall into that category should have no reason to fear the issuance of a report, assuming that they are paying taxes on their cash earnings.

The same may not be true for drug dealers, of whom the required reports would draw unwanted scrutiny. To accomplish their necessary financial goals after the imposition of this new requirement, drug dealers divided their currency deposits into smaller increments, each of which would be under the US\$10,000 triggering amount for a CTR. To redress this phenomenon, Congress created the crime of "structuring currency transactions" to avoid the reporting requirement. Where bank records show that someone made several US\$9,900 deposits at several different banks in the same day, prosecutors can ask the jury to infer that the person had a large corpus

of cash and intentionally structured it to avoid the CTR requirement, thereby committing a crime.

The structuring offense (31 U.S.C. § 5324) is an example of a carefully crafted statute that prohibits conduct that is not inherently offensive (making several large cash deposits in a single day) in those circumstances that separate the innocent from the guilty. It effectively closed a loophole available to drug dealers who aspired to use the U.S. financial system to wash their illegal proceeds, forcing them to rely on other means. If persons other than drug dealers were ensnared in the process, then such people would have been limited to those who had reason to fear (sometimes unknown to the prosecutors, even after conviction) the generation of a CTR. Sometimes, the motive for the structuring and the illegal nature of the structured funds remains unknown, even after the conviction.

This specific example of policymaking, the challenge to which reached the Supreme Court,<sup>7</sup> is less challenging than those in the counterterrorism area, where, unlike the act of depositing cash in excess of US\$10,000, the peripheral conduct is sometimes constitutionally protected.

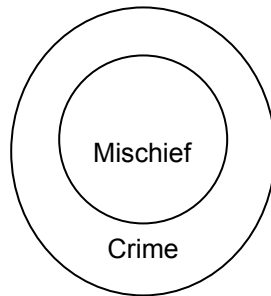
### **The Counterterrorism Crime Challenge**

Use of a simple device illustrates this law enforcement challenge, a construct referred to as “overinclusive” targeting. This concept and its converse, “underinclusive” targeting, are used in U.S. constitutional jurisprudence to describe the standards for determining the constitutionality of laws that make distinctions between classes of people. Under the Equal Protection Clause of our Fourteenth Amendment, the constitutionality of such government-drawn distinctions depends on the nature of the classification (racial, gender, alienage, income level, etc.), the state’s interest, and how closely the classification is drawn to achieve such interest.

In formulating criminal laws, governments are essentially creating a classification. Upon its enactment, a crime creates two classes of people: (a) those who are prosecutable under the statute and (b) those who are not. Persons in the first category, when charged with the crime, sometimes claim that the crime makes an unconstitutional distinction between what they are accused of doing

and the conduct of other people that is not criminalized. Sometimes, they advance another constitutional argument: the enactment of the crime unconstitutionally infringes on their right to express themselves freely or associate with whomever they choose. These arguments are depicted by Figures 1–3.

**Figure 1. Overinclusive Targeting**

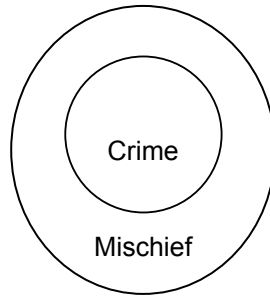


In the case of overinclusive targeting (Figure 1), the person charged claims that his conduct, while perhaps within the larger circle, is outside of the “mischief circle.” His argument:

*The crime I am charged with committing arbitrarily ensnares me in something that should not be prohibited, because my conduct is outside the realm of “mischief” and is no more offensive than the type of conduct of other people who are not charged with this crime.*

Note that this is the type of argument that would be made by the non-drug dealer charged with structuring. It is, essentially, “I may be a lot of things—tax cheat, bad husband who wants to hide assets from my wife—but I am certainly not a drug dealer, which is what the structuring offense is designed to capture.”

**Figure 2. Underinclusive Targeting**



In the case of underinclusive targeting (Figure 2), the person is charged with conduct that fits within the interior “crime” circle. Her argument:

*While I may have done something that I should not have done, look at all of the other people who did the same sort of thing but whose conduct lies outside of the inner circle of “crime.” If you are serious about stopping the misconduct in which you are accusing me of engaging, the crime I am charged with should include them as well, and is unfair as applied only to me.*

Neither of these two arguments, cloaked as they are in notions of fairness, is likely to gain much traction with American courts. Motions to dismiss are generally not granted on unfairness arguments by criminal defendants. These arguments are essentially public policy arguments, by self-interested persons who find themselves ensnared in particular crimes. The better arguments would consist of a claim that the prosecution infringes on constitutionally protected activity or fundamental rights.

In the first example, the person claiming to be aggrieved by the overinclusive targeting might argue:

*I am charged with the crime of doing something that is protected by the First Amendment. While I do not contest the government’s right to punish those people who actually detonated the bomb, you should not lump me into their scheme simply because I believed in their cause and was present in the room when they were planning the*

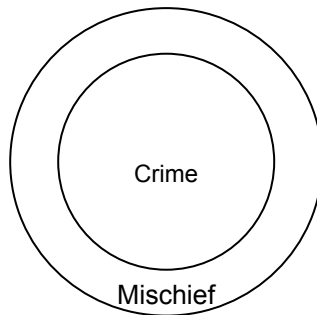
*attack. By doing so, you are seeking to punish me for my legitimate exercise of First Amendment rights, while chilling the exercise of such rights by other people who will notice what you are doing to me and be deterred from expressing themselves.*

The second person, complaining about the underinclusive targeting, might argue:

*Your prosecution of me for committing an act of terrorism overlooks other acts of terrorism committed by people motivated by things other than the right to Palestinian freedom and self-determination. You are selectively prosecuting me because of my race, while consciously overlooking the terrorism committed by radical Jews and Irish nationalists.*

To date, in the context of U.S. counterterrorism enforcement (described below), these arguments have failed, but they come closer to the type of arguments looked upon more favorably by U.S. courts. They also suggest the rarely achievable ideal, depicted in Figure 3.

**Figure 3. Optimal Targeting**



This ideal, which I refer to as “optimal targeting,” criminalizes virtually all of the mischief sought to be prevented, leaving few openings for criminal defendants to attack the enforcement program, either on constitutional or fairness grounds. In reality, criminal statutes and their enforcement are overinclusive or underinclusive, which does not present a problem if they do not infringe on constitutionally protected activity.

The concepts of overinclusive and underinclusive targeting are particularly helpful when taken a step further and applied to the operational challenges raised by the white-collar terrorist.

### **Philosophical Underpinnings of U.S. Terrorist Financing Enforcement Program**

The U.S. Constitution, as interpreted by the Supreme Court, recognizes certain financial transactions as protected by the First Amendment, in particular the guaranteed freedoms of speech and association. The act of providing funds is a form of speech and association. Accordingly, any legal restrictions on such conduct must be tailored to conform with the First Amendment. This is not to say that financial transactions cannot be regulated or restricted. The constitutionality of monetary limits on political contributions and of embargoes that prohibit U.S. citizens from engaging in certain foreign transactions, for example, is well established.<sup>8</sup>

Meanwhile, there is no question that some of the most lethal international terrorist organizations engage in legitimate philanthropic and humanitarian activity for people suffering within the regions in which they operate. For groups like Hamas and Hizballah, this activity is considered the benevolent counterpart to their violent activities, and is designed to win the hearts and minds of people in such regions while simultaneously killing innocent people through indiscriminate violence elsewhere.

Given the hybrid nature of many terrorist organizations, it would be an almost insurmountable law enforcement challenge to be required to trace the dollars coming from U.S. sources, through the shadowy Third World financial sector, to their ultimate use in purchasing bombs and bullets. Perhaps more important, even if such law enforcement efforts succeeded, it would be even more difficult to establish that the U.S.-based providers specifically knew that the funds were going to the malevolent, rather than humanitarian, purposes of the group.

These two factors led to the philosophical basis for the current U.S. terrorist financing statutory scheme: the notion that all money is fungible, and the benevolent intent of the donors cannot wash what is inherently a dangerous act—funding overseas groups that kill

innocent persons. The funds provided by the humanitarian-minded donor are just as useful to the terrorist organization as the funds provided by persons who intend such funds to be used for violence.

This recognition has led to an approach to terrorist financing enforcement that is increasingly being adopted by other countries and in multilateral fora. It involves list making. Starting in 1995, the United States adopted procedures resulting in the publication of lists of designated groups and persons that, according to facts contained in administrative records compiled for this specific purpose, are conclusively determined to be terrorists. Upon the inclusion of any group or person on these lists, it becomes a crime for anyone subject to United States jurisdiction to engage in financial transactions with the group/persons, even if the transaction itself is not designed to promote terrorism.

For American law enforcement, the list-making approach to terrorist financing effectively altered the challenge. Instead of tracing monies from our shores to their ultimate use in terrorist acts, the enforcement challenge now is to establish that persons here engaged in financial transactions with persons they knew were acting on behalf of designated terrorist groups and individuals. Because the crimes of terrorist financing do not require a completed crime, if we can establish sufficient proof of intent, persons within the United States can be prosecuted for transactions when the funds never make it overseas to their intended destination. Defendants merely need to agree to provide funds to a terrorist organization and send a payment in furtherance of this goal. This powerful law enforcement tool is the main terrorist financing crime of 18 U.S.C. § 2339B, known as the crime of providing “material support to designated terrorists.” Enacted in April 1996, this crime did not become fully operational until the Secretary of State issued the first list of “Designated Foreign Terrorist Organizations” (FTOs) on October 7, 1997.

### **Section 2339B and the Designation of Terrorist Groups**

Section 2339B prohibits anyone from providing “material support or resources” to a designated foreign terrorist organization. The offense portion of the statute reads:



**§ 2339B. Providing material support or resources to designated foreign terrorist organizations**

**(a) Prohibited activities.**

**(1) Unlawful conduct.** Whoever knowingly provides material support or resources to a foreign terrorist organization, or attempts or conspires to do so, shall be fined under this title or imprisoned not more than 15 years, or both, and, if the death of any person results, shall be imprisoned for any term of years or for life.

The Secretary of State designates FTOs, in consultation with the Attorney General and the Secretary of the Treasury. These designations are based on definitions contained within the Immigration and Nationality Act. FTO designations are valid for five years and are renewable. The first FTO list, announced by Secretary of State Madeleine Albright in October 1997, consisted of 29 organizations. Certain groups have been added and removed, and the current FTO list contains 43 groups.<sup>9</sup> The Secretary of State's FTO designations are the culmination of an exhaustive interagency review process in which information about a group's activity, taken from both classified and open sources, is scrutinized. The State Department, working closely with the Justice and Treasury Departments and the intelligence community, prepares a detailed administrative record that documents the terrorist activity of the proposed designee. Seven days before publishing an FTO designation in the *Federal Register*, the Department of State provides classified notification to Congress. Upon their announcement, designations are subject to judicial review, triggered by a challenge from the group itself. This has occurred a few times since the publication of the original FTO list. In addition, one lawsuit was filed independently by the prospective donors of two FTOs, arguing that the designation infringes on their First Amendment freedoms of speech and association, and seeking a declaratory judgment that the statutory scheme was unconstitutional. The constitutionality of the FTO designation process has been thoroughly upheld.<sup>10</sup>

The other two terrorist lists that are relevant to U.S. terrorist financing enforcement involve the International Emergency Economic Powers Act (IEEPA), which permits the prosecution of persons who engage in financial transactions with persons and

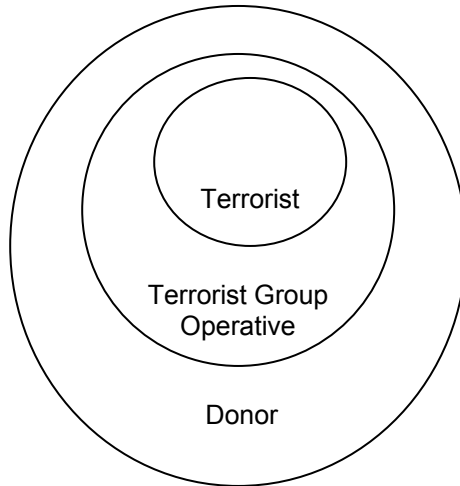
organizations the President has determined to be a threat to United States national security.<sup>11</sup> The U.S. Treasury Department administers these programs under its economic sanctions authority. The two lists are entitled Specially Designated Global Terrorists (SDGTs) and State Sponsors of Terrorism (SST). A third list, which contains groups and individuals whose conduct threatens the Middle East peace process, is referred to as Specially Designated Terrorists (SDTs), although its usefulness is limited to transactions that occurred between January 1995 and September 1997 since all SDTs are SDGTs, and many are FTOs.

The SDGT list is premised on Exec. Order No. 13224, which authorized the U.S. Treasury Department to block assets and freeze bank accounts of these designated groups/individuals.<sup>12</sup> There are currently over 450 SDGTs, and that number grows from week to week.<sup>13</sup> Any willful violation of these blocking orders is a criminal IEEPA violation.<sup>14</sup> The SDGT list now includes all of the organizations on the State Department's list of Foreign Terrorist Organizations, plus many more. Thus, there is a potential IEEPA violation in every § 2339B investigation. Unlike the FTO list, the IEEPA list of designated entities is not limited to foreign groups. The Texas-based Holy Land Foundation for Relief and Development (HLFRD), for example, was designated under IEEPA on December 7, 2001. It is also not limited to organizations, as the IEEPA list includes Usama bin Laden himself, as well as Hamas leader Mousa Abu Marzook. As a result, financial transactions with HLFRD, bin Laden, or Marzook, without the requisite Treasury licensing, are a crime, even though none of the three is an FTO.

### **Wider Benefits of the List-Making Approach to Terrorist Financing**

Just as the terrorist lists changed the American law enforcement landscape, they assist central bankers in their counterterrorism role. For central bankers, the main lists are issued by the United Nations pursuant to Security Council Resolution No. 1373.<sup>15</sup> As with American police, the central banker's job is made easier by these lists. How? The impact can be depicted visually in Figure 4.

**Figure 4: Scope of the List-Making Approach**



Consider this first in the context of law enforcement, with the American statutory regime described above. An American prosecutor obtains indictments against three different persons: (1) the terrorist group leader within the smallest circle; (2) the terrorist group operative in the middle circle; and (3) the person who knowingly provided funds to the Hamas operative, in the outer circle.

The third of these defendants, indicted under § 2339B, makes the following argument to the court:

*I am charged with doing something that is not inherently dangerous—providing funds to the charity of my choice. In making this donation to Hamas, I intended my funds to be used for philanthropic goals, never violence. The United States government, if anything, should encourage charitable gift giving. My decision to give to Hamas is protected by my First Amendment rights to express myself however I want, and to associate with whomever I choose. Moreover, people looking at what you are doing to me will naturally be deterred from giving funds to Hamas, and their First Amendment-protected activities will be chilled.*

The prosecutor responds:

*Section 2339B represents Congress' clear intent to dry up the U.S. source of funds for international terrorists. Under this statute, the United States announces the groups we view as designated foreign terrorist organizations. That action marks groups that use violence to achieve their political goals, and the fact that they may also engage in philanthropy does not change the terrorist nature of that organization. As a person within the United States, the defendant is prohibited by § 2339B from providing any funds to certain groups, including Hamas, no matter how the defendant intends Hamas to use his donated funds. This is a reasonably tailored prohibition, supported by clear legislative history and an administrative record, which comports with First Amendment jurisprudence, just as the laws that prohibit United States citizens from purchasing items produced with embargoed countries have been upheld. In addition, the statutory scheme has been upheld when challenged on these same grounds, by persons who are alleged to have engaged in the same type of conduct as the defendant.*

Note that the prosecutor's argument responds to the arguments of the defendant situated in the outermost ring, the one furthest removed from the violent activity depicted in the inner circle. With regard to the constitutionality of § 2339B as applied to particular facts, the conduct of the other two defendants is an even easier argument. That is, these two defendants would have a more difficult time arguing that their alleged conduct is protected expression or association. Faced with these arguments, U.S. courts have sided with the prosecutor.<sup>16</sup>

For the central banks, the promulgation of terrorist-related lists similarly reorients their task. It is no longer necessary for central banks to glean the nature of innocent-looking financial transactions and attempt to fathom the intent of the parties. The inclusion of a particular name on a list solves that problem. It represents a statement by the world's terrorism experts that there is sufficient basis to conclude that a particular entity or individual is involved in terrorism. With the terrorism lists, financial institutions are relieved of the burden of determining whether a particular transaction is clean or dirty. If the transaction involves an entity that appears on a terrorism list, the transaction is *de facto* dirty. The bankers' new operational challenge becomes determining whether the particular financial transaction involves such listed persons/entities, a task that can be made easier by increasingly available bank compliance software.

This task, however, will be complicated as designated terrorists react to the lists and disguise their identity or establish front companies to act on their behalf. This is inevitable, since terrorists are opportunistic criminals. While financial institutions, like their police counterparts, will enjoy the operational shortcuts that come from terrorist lists, they must continue to be vigilant in developing their own expertise and ability to discern suspicious activity from transactions that are designed to appear innocent. An important aspect of developing this expertise is familiarity with intelligence and the craft of those who practice it as a profession, the final part of this article.

### **The Concept of “Actionable Intelligence”**

Because terrorist financing is a national security matter that transcends national boundaries, it will involve foreign intelligence. Like their law enforcement counterparts who are new to this area, central banks should understand the concept of intelligence and the role intelligence concepts play in countering the financing of terrorism.<sup>17</sup>

The “intelligence cycle” is a well-known term among intelligence professionals. It refers to the collection, production, and dissemination of information. The term “cycle” denotes a never-ending process in which the needs of the recipient (the “consumers”) are constantly communicating with those responsible for developing the intelligence (the “collectors” and “producers”), who target their methods accordingly.

In theory, the goal of intelligence is always some action taken on its basis. Intelligence is produced for the benefit and use of operational decision makers. Within the United States, every agency that has a role in executing presidential decisions in the national security arena is a consumer of intelligence; they cannot offer options without having the best sources of information and analysis. “Raw intelligence” is a colloquial term meaning collected intelligence information that has not yet been converted into finished intelligence. Raw intelligence becomes “finished intelligence” through the analytical work of various experts within the intelligence cycle. The goal of the consumers is the receipt of “actionable intelligence”:

information that is sufficiently reliable for decision makers to rely on it in taking actions.

The standards for determining the reliability for a particular action depend on the standards that have evolved or been set by the particular consumer. For the law enforcement consumer, the ultimate form of actionable intelligence is *evidence*—facts that can be introduced in court—although law enforcement actions are sometimes taken on the basis of “lead” information that would not qualify as evidence. For other types of operational decisions, for example, whether to authorize military action or whether to place a particular name on a list of terrorist organizations, the standards may vary.

Where do the central banks fit within the intelligence cycle? The answer depends on the particular country. In some nations, the Financial Intelligence Unit (FIU) suggested by the Financial Action Task Force recommendations is located within the central bank. In some, the FIU is a collector of information. In others, it is a consumer of information collected by other government or private components.

The United States’ FIU is known as the Financial Crimes Enforcement Network (FinCEN), a component of the Treasury Department. Where does FinCEN fit within the U.S. intelligence community? The difficulty in answering this question reflects the changing nature of counterterrorism and intelligence within the United States, which is again illustrated by how American law enforcement has evolved to deal with the terrorist threat.

After 9/11, police officers and prosecutors ceased being merely consumers of intelligence. The USA PATRIOT Act permitted information sharing between intelligence and law enforcement that was previously proscribed. Information collected by grand jury subpoena or through judicially approved electronic intercepts in criminal cases is now shared with non-law enforcement components of the U.S. intelligence community. At the same time, personnel assigned to criminal law enforcement are now privy to the full range of foreign counterterrorism intelligence. With this change, law enforcement has become both a consumer and a collector of intelligence.

Is this not also true of the FIUs and of the central banks? Take the United States as an example. FinCEN is a *collector* of information. Like any intelligence agency, it develops intelligence products in accordance with the consumers' need for particular information and analysis. How does FinCEN collect? With regard to the raw intelligence it comes from the private sector, in reports that financial institutions are required to file with FinCEN under the Bank Secrecy Act.

In its relationship with the private sector, FinCEN is an intelligence *consumer*. It tasks the collectors—American banks—to collect and report certain information. This tasking is accomplished through Treasury-promulgated regulations in which banks are told what they should report, and how. The resulting intelligence—in the form of such documents as Suspicious Activity Reports, Cash Transaction Reports, and Currency and Monetary Instrument Reports—is collected, finished, and disseminated by FinCEN to its consumers.<sup>18</sup>

This U.S. example hopefully illustrates how central banks fit into the world of counterterrorism enforcement. Some central banks will be consumers of information collected by others. Others will collect, analyze, and disseminate financial information within their control, in hopes of providing actionable intelligence for their country's decision makers. No matter how a particular central bank fits within its country's legal and regulatory apparatus, the operational challenges will be similar to what is being faced by others throughout the world, including law enforcement professionals who, like their central bank colleagues, are continuing to think of creative ways to redress the problem of the white-collar terrorist support infrastructure. The reliance on terrorist lists makes central banks both collectors and consumers of intelligence, because these lists—though they are intentionally public—are an example of disseminated intelligence. Armed with these lists, the consumer becomes the collector, and the intelligence cycle repeats.

## Conclusion

The U.S. law enforcement experience does not provide the answers to every operational challenge faced by central bankers in countering the financing of terrorism. It is merely one perspective. It

is vitally important for experts from a variety of countries and backgrounds to get together to share experiences, through a variety of vehicles including conferences sponsored by the International Monetary Fund.



## Notes

This chapter was adapted from Jeff Breinholt, *Counterterrorism Enforcement: A Lawyer's Guide*, now available through the U.S. Department of Justice Office of Legal Education.

<sup>1</sup> There are some limited exceptions to this rule. For example, it is a U.S. crime to threaten to take the life of the President (18 U.S.C. § 871), and persons can be prosecuted on the basis of their associations under the Racketeer Influenced and Corrupt Organization (RICO) Act (18 U.S.C. § 1961 *et seq.*).

<sup>2</sup> See 18 U.S.C. § 2332b(g)(5).

<sup>3</sup> 18 U.S.C. § 2339A.

<sup>4</sup> U.S. money laundering laws prohibit the transfer of funds from a place in the United States to a place outside of the United States with the intent to promote a “specified unlawful activity” (SUA). 18 U.S.C. § 1956(a)(2)(A). The crimes of terrorism are SUAs.

<sup>5</sup> Air violence, for example, was addressed in the December 16, 1970 “Convention for the Suppression of Unlawful Seizure of Aircraft” (the Hague Convention) and the September 23, 1971 “Convention for the Suppression of Unlawful Acts Against the Safety of Civil Aviation” (the Montreal Convention).

<sup>6</sup> This requirement grew out of the Bank Secrecy Act (BSA), Pub.L. 91-508, Titles I, II, Oct. 26, 1970, 84 Stat. 1114 to 1124, which added nine sections to Title 12 of the United States Code. 12 U.S.C.A. § 1951 *et seq.* In 1982, provisions were added to Title 31 that require “certain reports or records where they have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism.” 31 U.S.C. § 5311. These records include those of “a resident or citizen of the United States or a person in, and doing business in, the United States ... when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency (31 U.S.C. § 5314), reports on exporting and importing monetary instruments totaling more than US\$10,000 (31 U.S.C. § 5316), and reports when a domestic financial institution is involved in a transaction of more than US\$10,000 in U.S. coins or currency (31 U.S.C. § 5313).”

<sup>7</sup> *Ratzlaf v. United States*, 510 U.S. 135, 114 S.Ct. 655, 126 L.Ed (1994).

<sup>8</sup> See *Buckely v. Valeo*, 424 U.S. 1, 96 S.Ct. 612, 46 L.Ed (1976).

<sup>9</sup> A list of these groups can be found at <http://www.state.gov/s/ct/rls/fs/2003/12389.htm>.

<sup>10</sup> See *Humanitarian Law Project v. Reno*, 205 F.3d 1130 (9th Cir. 2000); *People's Mojahedin Org. of Iran v. Dep't of State*, 182 F.3d 17 (D.C. Cir. 1999) (rejecting challenges by two designated groups); *National Council of Resistance of Iran v. Dep't of State*, 2001 WL 629300 (D.C. Cir. June 8, 2001) (groups that have sufficient U.S. presence are entitled to procedural due process).

<sup>11</sup> 50 U.S.C. § 1701 *et seq.*

<sup>12</sup> 66 Fed. Reg. 49,079 (September 23, 2001).

<sup>13</sup> A list of these designees can be found at <http://www.treas.gov/offices/eotffc/ofac/sanctions/t11ter.pdf>.

<sup>14</sup> 50 U.S.C. § 1705.

<sup>15</sup> See <http://www.un.org/Docs/sc/committees/1373/resolutions.html>.

<sup>16</sup> See *supra* note 10.

<sup>17</sup> The most accessible source of information on the structure of the U.S. national security apparatus is a CIA publication entitled *A Consumer's Guide to Intelligence*.

<sup>18</sup> See *supra* note 7.

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NADIM KYRIAKOS-SAAD, CHEONG-ANN PNG,  
AND JEAN-FRANÇOIS THONY

The systematic involvement of the International Monetary Fund (IMF) in anti-money laundering (AML) and (later) combating the financing of terrorism (CFT) matters was initiated through the establishment of the Offshore Financial Center (OFC) Program in July 2000. The purpose of the program was to offer a voluntary assessment of compliance by OFC with various international standards on banking, insurance, and other relevant sectors. It was also aimed at assessing vulnerabilities and threats to financial stability and the potential for contagion of offshore risks to relevant onshore economies.<sup>1</sup>

The OFC Program was established in the context of a call by the Group of Seven (G-7) governments to take action against the abuse of the global financial system with the view to ensuring that “its credibility and integrity are not undermined by crime, poor regulatory standards and harmful tax competition” by “offshore havens which undermine international standards of financial regulation.”<sup>2</sup> In particular, the G-7 governments called upon the international financial institutions “to strengthen governance and anti-money laundering measures in programs with member countries.” In establishing the OFC Program, the Executive Directors of the IMF also stressed that “effective anti-money laundering measures are important for the integrity of the financial system, as well as for fighting financial crime.”<sup>3</sup>

On April 13, 2001, the Executive Board of the IMF decided to enhance its contribution to the fight against money laundering, specifically through recognizing the Financial Action Task Force 40 Recommendations on Money Laundering (FATF 40 Recommendations) as the appropriate AML standard; endorsing the creation of a

methodology for assessing compliance with the standard; and incorporating AML concerns in the IMF's surveillance and other operational activities where macroeconomically relevant.<sup>4</sup> The Executive Board also recognized that more vigorous national and international efforts to counter money laundering were needed, including through the promotion of sound financial systems and good governance, the design and implementation of judicial and legal reform and other related capacity-building programs, and effective law enforcement. It was stressed however that the IMF's involvement should be strictly confined to its core areas of competence.

### **Principal Developments**

The events of September 11, 2001, reinforced the determination of the IMF. On November 12, 2001, the Executive Board stressed that the IMF has a key role to play in combating money laundering and terrorism financing as part of international efforts to prevent the abuse of financial systems and to protect and enhance the integrity of the international financial system.<sup>5</sup> The Executive Board agreed on a number of measures to intensify the IMF's work in this area and extend it to combating the financing of terrorism. The main decisions taken included expanding the joint IMF–World Bank AML Methodology Document<sup>6</sup> and IMF technical assistance to include aspects relating to anti-terrorism financing and to legal and institutional issues; applying the expanded methodology in OFC assessments (the pace of which would be speeded up), as well as onshore assessments in the context of Financial Sector Assessment Programs (FSAPs); introducing AML/CFT issues in the context of Article IV consultations on the basis of a voluntary questionnaire; enhancing the IMF's collaboration with the FATF, including by working closely and rapidly with the FATF on a suitable assessment process that is compatible with the uniform, voluntary, and cooperative nature of the Report on the Observance of Standards and Codes (ROSC) exercise, and by contributing to the revision of the FATF 40 Recommendations; increasing relevant IMF technical assistance to correct deficiencies in countries' anti-money laundering and anti-terrorism financing regimes identified in the course of FSAPs and OFC assessments; and, finally, to develop an IMF role in the coordination of such technical assistance.

In considering how the IMF could extend its activities to limit the use of financial systems for terrorism financing and to make its AML

work more effective, the Executive Directors stressed that the IMF's involvement in these areas should be consistent with its mandate and core areas of expertise. Recognizing that no single agency can resolve the problems independently, they also emphasized that the Fund should adopt a disciplined and collaborative approach that respects the expertise, scope, and mandate of other relevant institutions, and that the roles of the various institutions involved should be clarified.

### **Pilot Program and Comprehensive Methodology**

The year 2002 marked a deepening of the IMF's work in the area of AML/CFT. On July 26, 2002, the Executive Board conditionally added the FATF 40 Recommendations and FATF Special Recommendations on Terrorist Financing (together FATF 40+8 Recommendations) to the list of areas and associated standards and codes for the operational work of the IMF, and endorsed a 12-month pilot program of AML/CFT assessments and accompanying ROSCs that would involve participation of the IMF, the World Bank, the FATF, and the FATF-Style Regional Bodies (FSRBs).<sup>7</sup>

The Executive Board decided that assessments would be conducted in accordance with the comprehensive and integrated methodology based on the FATF 40+8 Recommendations and the assessment procedure should be compatible with the uniform, voluntary, and cooperative nature of the ROSC process. The methodology was endorsed by the FATF for its mutual evaluations in October 2002 and by the Executive Board of the IMF in November 2002.<sup>8</sup>

As part of the pilot program, which took place between October 2002 and 2003, a total of 33 assessments were carried out by the IMF and/or World Bank within the framework of the IMF's OFC assessments and the Bank/IMF FSAP,<sup>9</sup> and 8 mutual evaluations were carried out by the FATF and the FSRBs. Of the 33 Bank/IMF assessments, 18 were FSAP assessments, 13 were OFC assessments, and 2 were stand-alone assessments. Three of the mutual evaluations were carried out by the FATF and five by the FSRBs.

## **Revision of the FATF 40 Recommendations and the Comprehensive Methodology**

After completing an extensive review that included the participation of the private sector, the IMF/Bank, the FSRBs, and other interested organizations, the XIV Plenary Meeting of the FATF (June 16–20, 2003) issued a revised version of the FATF 40 Recommendations. Significant changes to the revised FATF 40 Recommendations included

- specifying a minimum list of designated categories of predicate crimes for money laundering;
- extending various AML requirements to financing of terrorism, including suspicious transaction reporting requirements;
- introducing risk-based application of customer due diligence (CDD), including enhanced measures for higher risk customers and transactions, correspondent banking, politically exposed persons, and business and transactions where third parties are relied upon for completing CDD;
- extending AML/CFT requirements, particularly CDD, record keeping, and STR requirements, to certain designated nonfinancial businesses and professions consisting of casinos, real estate agents, dealers in precious metals and stones, lawyers, notaries, other legal professionals, and accounting, trust, and company service providers; and
- prohibiting shell banks and improving transparency of legal persons and arrangements.

The revised FATF 40 Recommendations came into effect immediately, and a revised methodology was adopted by the FATF in February 2004. The revised FATF recommendations and the revised methodology were adopted by the IMF in April 2004.<sup>10</sup> The revised methodology differs significantly from the 2002 methodology: it reflects the significant changes included in the revised FATF recommendations and was informed by the experience the various assessor bodies and organizations gained in the course of their respective assessments, including, in particular, under the 2002 methodology.

The revised methodology, in contrast to the 2002 methodology, is structured along the lines of the revised FATF 40 Recommendations and the 9 Special Recommendations. The criteria relating to the Special Recommendations on Terrorist Financing are separate from the AML criteria, though, where applicable, they cross-reference the relevant AML criteria. While the new structure facilitates the determination by assessors of whether the FATF recommendations have been fully and properly implemented, the reports based on the assessments must be organized along the following four areas reflecting an effective AML/CFT system with an adequate legal and institutional framework: (1) laws that create money laundering (ML) and terrorist financing (FT) offenses and provide for the freezing, seizing, and confiscation of the proceeds of crime and terrorist funding; (2) laws, regulations, or, in certain circumstances, other enforceable means that impose the required obligations on financial institutions and designated nonfinancial businesses and professions; (3) an appropriate institutional or administrative framework, and laws that provide competent authorities with the necessary duties, powers, and sanctions; and (4) laws and other measures that give a country the ability to provide the widest range of international cooperation. In addition, an effective AML/CFT system requires the existence of certain structural elements—not covered in the FATF recommendations—whose absence may significantly impair the system itself. Such elements include, but are not limited to, (1) the respect of principles such as transparency and good governance; (2) a proper culture of AML/CFT compliance shared and reinforced by government, financial institutions, designated nonfinancial businesses and professions, industry trade groups, and self-regulatory organizations; (3) appropriate measures to combat corruption; and (4) a reasonably efficient court system that ensures that judicial decisions are properly enforced. Although the revised methodology does not include criteria for assessments of these areas, major weaknesses or shortcomings in these elements should be noted in assessment reports because of the overall debilitating impact they can have on an AML/CFT system.

Reflecting the expanded scope and detail of the revised recommendations, the revised methodology includes some 200 essential criteria, 20 subcriteria, and 35 additional elements. The essential criteria cover the elements that should be present in order to establish full compliance with the mandatory elements of each of the recommenda-



tions. In some cases, elaborations in the form of subcriteria are provided to assist in identifying important aspects of the assessment of the criteria. In addition, examples intended to assist assessors are included for a number of criteria. The additional elements are derived from nonmandatory elements in the FATF recommendations or from Best Practice and other guidance issued by the FATF, or by international standard-setters such as the Basel Committee on Banking Supervision; they are options that can further strengthen the AML/CFT system and may be desirable. Although they form part of the overall assessment, they are not mandatory and are not assessed for compliance purposes.

The four-level compliance rating system has been maintained under the revised methodology but is now more delineated. The four possible ratings of compliance are compliant, largely compliant, partially compliant, and noncompliant. In exceptional circumstances, a recommendation may be rated as not applicable. The ratings are defined as follows:

**Compliant.** The Recommendation is fully observed with respect to all essential criteria.

**Largely compliant.** There are only minor shortcomings, with a large majority of the essential criteria being fully met.

**Partially compliant.** The country has taken some substantive action and complies with some of the essential criteria.

**Noncompliant.** There are major shortcomings, with a large majority of the essential criteria not being met.

**Not applicable.** A requirement or part of a requirement does not apply, due to the structural, legal, or institutional features of a country—for example, a particular type of financial institution does not exist in that country.

### **The New Role of the IMF**

At the end of the pilot program, and following the revision of the standard and the assessment methodology, the Executive Board clarified and reiterated the commitment of the IMF to the global efforts

against money laundering and financing of terrorism in March 2004. Notably, the Executive Board endorsed the FATF 40+8 Recommendations as the standard for AML/CFT assessments and the application of the revised methodology for the IMF's work (including the preparation of AML/CFT ROSCs as part of the list of standards and codes for which ROSCs are prepared).

The Board also decided that AML/CFT assessments, whether prepared by the IMF or the World Bank (or the FATF or FSRBs), should continue to be included in all FSAP and OFC assessments. In addition, the Board emphasized that delivery of technical assistance is a key element of raising global compliance with the FATF Recommendations and welcomed the increased contribution of the IMF in its delivery of technical assistance in collaboration with other bilateral and multilateral providers of technical assistance.

What this means in operational terms is that the IMF will continue to contribute to the global developments in AML/CFT, principally by conducting country assessments and providing technical assistance, within the scope of its mandate and expertise. In this regard, the Executive Board agreed in March 2004 that assessing whether countries have the capacity to implement AML/CFT laws effectively is part of the core mandate of the IMF.

In practice, the workload for the AML/CFT assessments is shared between the FATF (and the FSRBs), the IMF, and the World Bank, and the results of the assessments (or mutual evaluations as in the case of FATF and the FSRBs) are incorporated in the ROSCs (which include results of other assessments, such as those for banking and insurance supervision) that are produced as part of the assessment process under an FSAP or OFC assessment. The ROSCs are circulated to the Executive Board of the IMF (and the Executive Boards of the World Bank and the IMF for an FSAP assessment). The emphasis for the AML/CFT assessments, as with the other assessments, is that they should be uniform, voluntary, and cooperative.

### **Technical Assistance**

IMF/Bank technical assistance (TA) has increased substantially as the two organizations intensified their provision of assistance, focusing principally on drafting of laws and regulations, implementation of

preventive measures and training, and the establishment and operations of financial intelligence units (FIUs). Between January 2002 and December 2003, there have been 85 country-specific TA projects benefiting 63 countries, and 32 regional TA projects benefiting more than 130 countries. Since the IMF Executive Board decision in March 2004, the IMF and the World Bank have delivered about 200 new projects and trained more than 1,000 officials around the world on the various aspects of AML/CFT.

Publication and outreach have also been an important part of the IMF/Bank TA efforts. Between January 2002 and December 2003, some of the principal AML/CFT publications include *Reference Guide to Anti-Money Laundering and Combating the Financing of Terrorism*, published by the World Bank in April 2003; *Suppressing the Financing of Terrorism: A Handbook for Legislative Drafting*, published by the IMF in July 2003; and *Informal Funds Transfer Systems: An Analysis of the Informal Hawala*, published by the IMF and the World Bank in September 2003. In June 2004, the IMF published *Financial Intelligence Units: An Overview*.

## **Conclusion**

The involvement of the IMF in AML/CFT efforts introduced paradigmatic changes to the work of the international community in this area. It is generally agreed that the IMF's efforts contributed to bringing a new dimension, dynamism, and universality to AML/CFT work. However, a number of elements of the new architecture are subject to considerable tension and warrant monitoring in the period ahead. Some of the basic assumptions on which the overall AML/CFT strategy is built are being questioned. Generally, some analysts have argued that considerable efforts are being exerted at disproportionate costs on the basis of a flawed strategy with few results, if any. An analysis of the efforts and a qualitative assessment of the strategy will have to be effected at regular intervals in the not-so-distant future and corrections introduced, if necessary.

On another level, the IMF continues to be seen by many as a reluctant participant in AML/CFT efforts. While there are no doubts about the legendary dedication of its staff, the IMF as an institution is sometimes believed to be having second thoughts about the wisdom and the appropriateness of its involvement in this area. These interro-

gations are being raised in the context of a more comprehensive soul-searching exercise by the institution as to its strategy in the medium term. While a number of analysts consider that the IMF, in order to remain relevant in the era of globalization, should resolutely embrace its role in AML/CFT issues, the IMF itself continues to be unsure as to how it should adapt in these changing times. This is also taking place in the context of calls for streamlining the IMF's activities and a zero-growth budget that appear to be at odds with the tasking of the institution with additional missions and apprehensions that these new tasks will be insufficiently funded.

There are a number of specific issues that will continue to constitute stimulating challenges in the period ahead. One such issue is the political will of states in addressing AML/CFT issues and the optimal use and coordination of technical assistance resources. Another issue that will need to be addressed derives from the architecture that was designed to conduct AML/CFT assessments. As mentioned above, AML/CFT assessments are now conducted under a unified methodology by a number of vastly different organizations and bodies. How these bodies will conduct their assessments in order for their outputs to be of similar quality is an open question. Initial analysis of a number of reports conducted under the first AML/CFT methodology has shown that these reports have not yet attained satisfactory uniformity with regard to quality and consistency. Significant efforts will have to be made in the period ahead to ensure that the approaches by the different bodies and organizations to measure states' compliance with AML/CFT standards are reasonably uniform and produce highly consistent reports of satisfactory quality.

## Notes

<sup>1</sup> IMF, *Offshore Financial Centers—The Role of the IMF* (June 23, 2000). See also Financial Stability Forum, *Report of the Working Group on Offshore Centers* (2000).

<sup>2</sup> Communiqué of the G-7 Finance Ministers and Central Bank Governors, Tokyo, January 22, 2000.

<sup>3</sup> IMF, “IMF Board Reviews Issues Surrounding Work on Offshore Financial Centers,” Public Information Notice No. 00/62 (July 26, 2000).

<sup>4</sup> IMF, “IMF Executive Board Discusses Money Laundering,” Public Information Notice No. 01/41 (April 29, 2001).

<sup>5</sup> IMF, “IMF Board Discusses the IMF’s Intensified Involvement in Anti-Money Laundering and Combating the Financing of Terrorism,” Public Information Notice No. 01/120 (November 16, 2001).

<sup>6</sup> See IMF and World Bank, “Twelve-Month Pilot Program of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Assessments—Joint Report on the Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 8 Special Recommendations Supplementary Information” (March 2004), <http://www.imf.org/external/np/aml/eng/2004/031604.pdf>, which includes as an Annex, “Methodology for Assessing Compliance with AML/CFT Standards,” [hereinafter “the methodology”].

<sup>7</sup> IMF, “IMF Advances Efforts to Combat Money Laundering and Terrorist Finance,” Public Information Notice No. 02/87 (August 8, 2002).

<sup>8</sup> On the development of the methodology, see Nadim Kyriakos-Saad, “The Methodology for Assessing Compliance with Anti-Money Laundering and Combating the Financing of Terrorism Standards,” in IMF, *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington: IMF, 2005), at 265.

<sup>9</sup> The FSAP is a program developed pursuant to the Asian financial crisis of the late 1990s to identify strengths, risks, and vulnerabilities of member countries’ financial systems and assess observance of financial sector standards, codes, and good practices.

<sup>10</sup> IMF, “IMF and World Bank Enhance Efforts at Combating Money Laundering and Terrorist Financing,” Press Release No. 04/70 (April 2, 2004).

## **VI. CONFLICTS OF INTEREST AND MARKET DISCIPLINE IN THE FINANCIAL SECTOR**

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EUGENE N. WHITE

Recent scandals in the financial industry in the United States have raised the question of whether the market can adequately control conflicts of interest. The policy responses to these recent corporate scandals suggest that markets are relatively ineffective and imply that new regulation is needed to prevent any further loss of investors' confidence in the financial system. These reforms are not costless and they may compromise the synergies that have determined the structure and efficiency of the financial system. If investors have not been served well by the market, can better incentive and governance mechanisms be designed by the government at a low cost to the efficiency of the financial system?<sup>1</sup>

### **Why Conflicts of Interest Cannot Be Eliminated**

The quest for synergies, the benefit from combining multiple activities within a financial institution, is one of the driving forces behind the development of financial institutions. However, synergies and conflicts of interest are a package deal. You cannot eliminate one without eliminating the other. The information approach to financial markets reveals the nature of this problem, which is at the core of the function of any financial institution.

Reliable information is required for markets to perform their economic function of channeling funds to businesses and households with the greatest productive opportunities. While this is essential, the asymmetric relationship between lenders and borrowers creates a major impediment. The party on one side of any financial contract has less accurate information than the party on the other side, creating the possibility that the party with more information may be able to take advantage of the situation.



In the simplest example, business managers have better information about their firm's returns and risk than do the purchasers of its securities or a bank's loan officers. Such an information asymmetry can lead to problems of adverse selection and moral hazard. Adverse selection occurs before a transaction is consummated; for example, managers who want to divert funds for their own pay or perquisites or further engage in risky ventures will be the most likely to seek external funds. If a bank or an investor grants them funds, their selection will make it more likely that their overall set of investments will perform below what was expected. Furthermore, investors who are unable to screen out bad from good investments may decide not to invest. Moral hazard occurs after the financial transaction has taken place when managers may, in the absence of an incentive to do otherwise, misallocate funds because bankers or investors have not been able to adequately monitor their behavior. Moral hazard may also discourage investors who may reduce lending.

While individual investors may conduct their own screening and monitoring of managers, they will face substantial problems. Investors may invest in information and become well informed, but they will become subject to free-rider behavior by others who observe their decisions and freely benefit from their investment, thus discouraging further investment. Also, an investor may not be an efficient collector of information if there are economies of scale and scope. Consequently, investors may turn to delegate the task of screening and monitoring to specialist financial institutions. Thus, analysts in investment banks can advise numerous clients on what securities to buy; auditors may opine on accuracy of the accounts presented by management, and rating agencies will rank the relative riskiness of securities for thousands of investors. These are fee-based services that permit investors to decide where to place their funds, but they may delegate investment as well as information collection to intermediaries that pool funds from the public in a diversified portfolio designed with private information they have collected. Yet, the problem of monitoring is inescapable, since investors using the services of financial institutions need to monitor them to ensure that they are providing accurate information and are appropriately investing their funds. Hence to be successful, financial institutions must convince or signal to their customers that they are adequately monitoring their employees.<sup>2</sup>

Economic theory typically treats financial institutions as though each type of institution solved one kind of informational asymmetry; however, institutions that have learned how to manage one information asymmetry often possess skills that may be used to handle others. Banks have long-term customer relationships, which they use to obtain information about firms' resources, cash flows, and other characteristics and reveal more confidential information. Financial institutions gain cost advantages because they can exploit cross-sectional information across customers, becoming low-cost producers of information for complementary financial services.

Such synergies or economies of scope provide producers and customers substantial benefits, but they also create potential costs in the form of conflict of interests. For the financial industry, conflicts of interest may be defined as arising when a financial service provider, or an agent within such a service provider, has multiple interests that create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial markets.

The combination of financial services in one intermediary creates conflicts of interest that may be exploited. If the firm or individuals within the firm can exploit conflicts of interest, they do so because they can benefit from the information asymmetries vis-à-vis customers. This behavior will obstruct the efficient allocation of funds to their most productive uses. But behavior that exploits a conflict of interest will, once recognized, reduce the reputation of an institution. Consequently, the existence of a conflict does not imply it will be exploited if the institution places a high value on its reputation. The implication is that public policy remedies may not be required to control the exploitation of conflicts. When they are necessary, government intervention to reduce conflicts needs to be balanced against any reduction in the economies of scope.

### **Conflicts of Interest in Investment Banking**

Investment banks gain economies of scale and scope, by providing financial services that tackle informational asymmetries in the primary and secondary capital markets. They combine a large variety of activities that include floating new and seasoned securities,

advising on mergers and acquisitions, serving as brokers or dealers, providing research, and making markets.

In the scandals that erupted after the collapse of stock markets in 2000, most attention has been focused on the conflict of interest between providing research to investors and underwriting initial public offerings. Research analysts identify and monitor companies for clients, helping to reduce the problems of adverse selection and moral hazard. The investment bank that serves as the lead underwriter for a syndicate acts as the delegated monitor for individual investors and the rest of the syndicate, by collecting the vital information on the firm issuing a new security, thereby gaining an information advantage. Its research analysts should be able to offer better recommendations to buy and sell stocks and better forecasts of performance. In addition, the lead underwriter usually is the dominant market maker. Information synergies from underwriting, research, and market making provide a rationale for combining these distinct financial services.<sup>3</sup> An investment bank's success at combining these activities will contribute to its reputation and profitability.

When an investment bank serves two clients, a conflict of interest may arise. Issuers will benefit from overly optimistic research while investors will want unbiased research. If the incentives at the investment bank for the provision of these two activities are not appropriately aligned, employees on one side of the firm will be tempted to distort information to the advantage of their clients and the profit of their department. To manage this conflict of interest, compensation must be set appropriately for research analysts. Setting compensation to produce the correct incentives is difficult because the information that analysts generate for investors is not a purely private good and cannot be limited to the firm's clients. Hence, it is not surprising that brokerages find pricing their services difficult and do not often charge clients for research.<sup>4</sup> The evaluation of analysts' performance is also a problem because they provide multiple services. During the stock market boom, some stock prices moved far away from fundamentals, increasing the reputations of analysts who correctly picked these stocks at the expense of those who focused on accurate forecasts of earnings.

While compensation rules vary among firms, an analyst's external reputation is important for compensation. Their external

reputation is influenced by the *Institutional Investor*'s polls<sup>5</sup> that rank analysts on buy/sell recommendations, earnings forecasts, reports, and overall service. Analysts' reputation is important not just for brokerage customers; it is also used as a marketing tool for investment banks in the initial public offering (IPO) market. A survey of chief executive officers and chief financial officers whose firms issued IPOs in the 1990s reported that most considered the reputation of a research department in the choice of a lead underwriter.<sup>6</sup> Analysts' support is often considered part of an implicit understanding between underwriter and issuer. Lastly, over the longer run, analysts' focus on the development of industries gives them a highly specialized knowledge that may assist underwriters in screening new companies.

When analysts are compensated by underwriting departments, there will be a strong conflict of interest potential. It will be most acute if the IPO market is highly profitable relative to brokerage because it will induce analysts to bias their reports in favor of issuers. In a soaring market, the short-term payoff for an analyst may outweigh the benefits of investing in a long-term reputation, being tempted to promote hot issues to expend the firm's reputational rents.

The boom market of the 1990s created conditions that induced analysts to exploit this conflict of interest. IPOs were primarily technology stocks, and the quality of companies going to market changed dramatically.<sup>7</sup> Most IPO companies had several years of established positive earnings in the 1960s to the 1980s, but the number of issuers with negative earnings soared to nearly 80 percent in 1999–2000. They may have had long-term potential, yet stock prices were moving away from their conventional relationships with fundamentals. Investors seem to have ignored these standard signals. They seem to have given more attention to target prices and other information, improving most optimistic analysts' reputations.

When IPO markets boomed, media attention focused on analysts' pronouncements. There appears to have been pressure on them to join in the optimistic promotion of stocks. The story of Henry Blodget is one of many striking examples. In 1998, most analysts held that Amazon.com was overvalued at US\$240; Jonathan Cole of Merrill Lynch believed US\$50 to be a reasonable price. Henry Blodget at Oppenheimer and Co. set a price target of US\$400. When

Amazon.com surpassed it, he was hailed as a guru; Cole departed and Merrill Lynch hired Blodget. Rewards for optimism spread through the industry. Studies of the movement of analysts from job to job to higher or to lower status brokerage houses have found that while analysts were rewarded for the relative accuracy of earnings forecasts, those who were more optimistic than the consensus were also more likely to experience favorable job separations.<sup>8</sup> Promotions for optimism became more important by the late 1990s.

While analysts influence investors, and their buy/sell recommendations are treated as “new” information that moves the market,<sup>9</sup> it is not clear that the analysts intended to deceive customers. While analysts made far more buy than sell recommendations in the boom, the ratio changed little after the collapse of the market. Furthermore, many research-only houses where there was no potential conflict also had far more buy than sell recommendations.<sup>10</sup>

What evidence is there that analysts tried to exploit conflicts of interest? Some answers are found in the differential behavior of analysts at underwriting and non-underwriting banks. Owing to their key position, lead underwriters’ analysts’ reports should carry extra weight and their predictions should be unbiased and more accurate than those of other analysts. Consequently, the market should react more to their announcements than to reports of other analysts. But, if they are biased, underwriter analysts will issue relatively more positive recommendations for firms that trade poorly in the IPO aftermarket. If the market recognizes the potential conflict of interest, then investors should discount underwriter analysts’ recommendations relative to non-underwriter analysts.

A 1999 study examined the “buy” recommendations of lead underwriters and other analysts for IPOs after the Securities and Exchange Commission’s (SEC’s) 25-day post-IPO “quiet period” from 1990 to 1992.<sup>11</sup> The findings showed that in the month after the quiet period, lead underwriters’ analysts made 50 percent more buy recommendations than other firms’ analysts for the same securities, suggesting some conflict of interest. But stock prices of firms recommended by lead underwriting banks declined during the quiet period, while other banks’ picks rose. The market recognized the difference in the quality of information. The excess return at the recommendation date is 2.7 percent for underwriters’ analysts and 4.4

percent for other analysts. Considering a two-year holding period from the IPO date, the performance of other analysts' recommended issues was 50 percent better than the performance of underwriters' recommendations. In addition, the same investment banks made better recommendations on IPOs when they were not the lead underwriter, implying that it is not a difference in analyst's ability but an underwriter bias.<sup>12</sup> The finding that the market discounts analyst optimism is also supported by survey data. A study found that 86 percent of the professional money managers and buy-side analysts said that they discounted the recommendations and reports of analysts when there is an investment banking relationship between the bank and the company analyzed.<sup>13</sup>

The outbreak of the post-crash scandals did not lead to an extended inquiry and policy debate. Instead, remedies were abruptly imposed by the "Global Settlement" reached on December 20, 2002 by the SEC, the New York Attorney General, NASD (formerly the National Association of Securities Dealers), the North American Securities Administrators Association, the New York Stock Exchange, and state regulators with the 10 largest investment banks.<sup>14</sup> The five key terms of the agreement were (1) firms are required to sever the links between research and investment banking, including analyst compensation for equity research and analysts accompanying investment banking personnel on road shows; (2) the practice of spinning of IPOs is banned;<sup>15</sup> (3) each firm is required to make public its analyst recommendations, including its ratings and price target forecasts; (4) for a five-year period, brokerage firms will be required to contract with no fewer than three independent research firms to provide research to their customers. Regulators will choose an independent consultant "monitor" for each firm to procure independent research to ensure that investors get objective investment advice; and (5) total fines of US\$1.4 billion will be levied that are partly for retrospective relief, independent research, and investor education.

To a considerable degree, this settlement attempts to socialize research. Taxing firms to fund independent research will create an incentive for them to reduce their own internal analysis and lower its quality. Separation between analysts and underwriters with some type of firewalls is appropriate, but complete separation is mistaken. The design of the Glass-Steagall Act of 1933 to separate commercial and investment banking ultimately failed, suggesting that a similar rem-

edy here is misguided. The market already discounted lead underwriters analysts' recommendations, making firms subject to some degree of market discipline. Firms will now have to have a separate staff for underwriting to perform the analysis, raising costs and losing some economies of scope. Market discipline was not permitted to take its course, and discipline by loss of reputation and litigation where conflicts were exploited by individual firms was preempted. The banning of spinning, however, is probably appropriate as it will ensure that insiders do not take advantage of outsider investors, exploiting the lack of information about how shares are distributed.

The global settlement relies heavily on separation and the socialization of research as remedies. An alternative approach would be to increase the ability of the market to discipline firms by increasing disclosure to investors of underwriting relationships, complementing this with supervisory oversight.

### **Conflicts of Interest in Auditing**

To judge the usefulness of accounting statements, investors depend on auditors to overcome the informational asymmetry between shareholders and managers. Managers provide a set of accounts to demonstrate how they have used the firm's resources, but this act does not eliminate the inherent agency problem. To ensure the reliability of these accounts, auditors can provide an independent assessment of the accounts prepared by managers and attest to the quality of information. The information collected by an audit firm has many potential uses beyond an audit report. Auditors have branched into new consulting services, notably tax advice, accounting, management information systems, and strategic advice, commonly referred to as management advisory services (MAS). These complementary services have economies of scope, but they create two potential sources of conflict of interest: (1) auditors may bias their opinions to limit any loss of fees in the "other" services, and (2) auditors may be called upon to evaluate tax and financial structures that were designed by their non-audit counterparts. Both conflicts may lead to biased audits, with the result that less information is available in financial markets. As in investment banking, individuals or firms can benefit from the exploitation of these conflicts of interest

because of the reputation that auditing firms have built up with investors.

An audit opinion is expressed in a report attesting to whether the financial statements provide what is known as a “fair presentation” or “true and fair view” of the performance and position of a firm. To form judgments, investors require standards for comparisons, which were originally developed in the nineteenth century by professional accounting societies that evolved into the American Institute of Certified Public Accountants (AICPA). Until the New Deal, there was no federal regulation of accountants and auditors. The collapse of the stock market in 1929 led to the passage of the Securities Act of 1933, which required companies offering shares to the public to submit regular financial statements certified by an independent public or certified accountant. The Securities Exchange Act of 1934 created the Securities and Exchange Commission, which was given jurisdiction over the accounting profession and its rules. The SEC delegated its accounting and auditing rule-making authority to private standard-setting bodies with self-regulation and SEC oversight. In financial accounting, the task of setting standards was delegated to AICPA committees, which evolved into the Financial Accounting Standards Board (FASB). For auditing, the AICPA retained its standard-setting role in the Auditing Standards Board. The rules for auditing govern the conduct of an audit and the nature of the reports, and provide monitoring by peer reviews and the Public Oversight Board. As a result of the auditing scandals, much of this standard-setting and oversight has been taken over by the government. The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB). Under the SEC’s oversight, the PCAOB will register accounting firms and establish rules for auditing, conduct inspections and investigations with the power to hold disciplinary proceedings, and impose sanctions. The PCAOB has indicated its intention to take over the rule-making authority for auditing standards, while leaving accounting rules in the hands of the FASB.

Because of the information that they provide, investors depend heavily on auditors. Empirical evidence reveals that favorable opinions issued by audit firms with a strong reputation are valued more than those issued by firms with weaker reputations. One study found that the use of a big-six auditor (as the six largest U.S. accounting firms are called) reduces the rate of return required by investors for a



firm and that this effect is almost three times larger for non-investment grade issuers, where information asymmetries are greater.<sup>16</sup> Respect for audit reports is so great that there is acknowledged to be an “expectations gap.” Another study<sup>17</sup> discovered that there is a large difference between the perception of what an audit opinion is intended to convey and what it actually accomplishes.<sup>18</sup> Many users of audits believe that an unqualified audit opinion indicates that the entity is financially sound and that there is no fraud or illegal activity. These expectations are widely held, in spite of the fact that in the United States the audit opinion only indicates that management’s presentation of the financial information is a fair presentation of the position and performance of the company and conforms to generally accepted accounting principles (GAAP).

Audit failures, particularly those appearing to arise out of perceived conflicts of interest, caused a demand for reform. The conflict most frequently discussed in the popular financial press arises from an auditor providing non-audit services. As in the case of research and underwriting, the conflicts of interest arise because services were combined to exploit economies of scope. Auditing firms are natural consultants because they gather and assess a wide array of information that enables them to evaluate management’s accounting decisions. Such expertise has natural information synergies with consulting services. This alliance of activities was furthered as corporate accounting systems became computerized, and auditing firms soon specialized in computerized management information systems. In the early 1980s, auditing firms emerged as powerhouses of the consulting business, with the largest entering the ranks of the top 10 global consulting firms. The leading firm was Andersen Consulting, which was almost solely a systems-oriented consulting firm.<sup>19</sup>

While there are many potential conflicts of interest, they will not be exploited unless encouraged by the incentive structure. Most studies find little evidence for widespread exploitation. One such study found that audit clients have incentives to limit non-audit purchases from incumbent auditors.<sup>20</sup> Their conjecture is that a perceived reduction in auditor independence reduces audit credibility, adding agency costs for companies as the value of the auditors’ monitoring role is reduced. More recently studies have examined whether auditors’ fees for MAS are associated with abnormal accruals, used as a

proxy for earnings management<sup>21</sup> and biased reporting. Another study found that non-audit fees are positively associated with small earnings surprises and the magnitude of discretionary accruals.<sup>22</sup> Using a U.K. data sample, where there is greater disclosure of audit and non-audit fees,<sup>23</sup> a further study saw no significant effect of abnormal accruals on audit fees or non-audit fees. In addition, they discovered that higher fees for non-audit services decreased abnormal accruals and interpreted this finding as evidence that non-audit services improve financial management. Others have also found no evidence that non-audit service fees impair auditor independence.<sup>24</sup> Auditors were more likely to issue qualified audits to clients that pay higher audit fees, consistent with a risk-based propensity to audit more; this finding was supported by a study that ascertained that risky clients have higher fees because of extra effort expended by auditors.<sup>25</sup>

It appears that auditors expend greater effort to address aggressive or risky accounting decisions made by clients. Although conflicts of interest have long been a concern, there appears to be no systematic pattern of exploitation. Yet, the rapid growth of MAS activities, followed by audit failures, have produced demands that auditing be separated from non-auditing services. Congress responded to this perceived problem in Section 201 of the Sarbanes-Oxley Act of 2002, which makes it unlawful for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including bookkeeping, financial information systems design, appraisals, internal audit outsourcing, management functions, and actuary, broker, dealer, investment advisor, investment banker, and legal services, and any other services that the PCAOB determines are impermissible. This drastic measure will eliminate not only potential conflicts of interests but also economies of scope. However, research suggests that conflicts of interest may not have been an overwhelming problem for audit firms. Instead the loss of auditor independence, the use of the partnership form for multiproduct firms, and litigation risk may have been the most important ingredients in the recent audit failures.

Auditing firms have been primarily organized as partnerships; and until the 1980s, the managing partners, governance structure, and profitability were dominated by the audit side of the firms. In the 1990s, MAS activities and revenues grew dramatically and audit profits were under increased competitive pressure and litigation risk.<sup>26</sup>

The partnership structure meant that non-audit partners had to share their growing revenues with the audit side and incur increased risk. Power struggles erupted, and the battle was most intense at Arthur Andersen. In these struggles, audit partners were pressured to increase revenues, and the dominance of local offices by single clients played an important role. Many of Arthur Andersen's largest failed clients, Enron, WorldCom, Qwest, and Global Crossing, were the largest companies in their local regions. The manager of a regional or city office would be wary of taking a negative stance on an audit that would risk losing the client. The loss of an Enron or WorldCom account would have been devastating to a local office and its partners even if it were only a small part of firm-wide revenues and profits. Whether this problem was systemic is unclear. For example, one investigation analyzed the influence of large clients on office-level auditor-reporting decisions and found no evidence of it influencing accruals.<sup>27</sup> This study, along with another,<sup>28</sup> found the evidence consistent with auditors reporting more conservatively for larger clients because these clients pose greater litigation risk and hence more reputational risk.

Concern over preservation of an audit firm's reputation is the driving factor behind litigation risk. Class action lawsuits, filed on behalf of shareholders, beginning in the 1970s, claimed that declines in share prices were caused by faulty auditing.<sup>29</sup> Litigation defeats imposed financial penalties and higher insurance costs, plus a loss of reputation. As a result, audit firms focused attention on reducing litigation risk, assessing the risk of their practices and clients. The national offices of audit firms began to perform risk assessments of clients and practices to manage these costs. Firms adjusted their activities to protect themselves from litigation. Auditors and corporations sought and relied upon an increased codification of auditing and accounting standards. The adherence to these rules facilitated a legal defense of compliance with rules.<sup>30</sup> Auditors shifted their focus from opining on whether financial statements fairly present the "true" financial condition and performance of the company to compliance with the detailed GAAP rules. Managers were able to argue now that audit opinions should concentrate on compliance with the rules, shifting attention from performance and obscuring the true economic condition of companies. The focus on GAAP rules thus was another vital part of the debacle at Enron and other companies.

The decline of auditor independence also threatens the effectiveness of audits. In principle, firms have an audit committee of the board of directors that is supposed to monitor auditing to prevent any conflict of interest between the auditors and management. However, audit committees were rarely in complete charge. Executive officers have often become the primary decision makers, selecting the audit firm and negotiating the fees. This conflict of interest can only be remedied by a change in the governance structures.

Although the Sarbanes-Oxley Act addresses some issues, the emphasis on separation by function is not the key and may well lower the effectiveness of auditors. It is unlikely that the proscription of non-auditing services would have prevented the recent audit failures. The market can impose considerable discipline, as Arthur Andersen paid the ultimate price by its demise. To bolster the drive for reputation, some reforms are necessary. As Section 301 of the Sarbanes-Oxley Act recognizes, the corporate governance structure of companies needs to be altered so audit committees, not management, hire and determine the compensation of auditors. A fundamental change is also required to shift auditors away from focusing on the adherence to detailed prescriptive accounting rules. The continued focus on the codification of accounting and auditing standards will not improve the quality of auditors' reports and may lead to more manipulative innovations to hide companies' true conditions. Lastly, audit firms themselves need to adjust their internal governance and compensation structures to limit the problem of large-client dominance of local offices and of competition between audit and non-audit services. Firms can devise their own structures, but the PCAOB may help by monitoring and encouraging the development and use of best-practice compensation and performance measurement structures.

### **How to Resolve Conflicts of Interest**

Can the market control conflicts of interest? Market discipline hits firms hard with pecuniary penalties and promotes the development of institutional structures that limit conflicts and signal the firm's intent to the public. Litigation is an important part of market discipline. It is effective, as exploitation of conflicts is not uniform across the financial industry. While litigation may be the appropriate response to discipline specific firms and individuals as part of an

overall market solution, legal liabilities and penalties need to be carefully designed, as demonstrated by the behavior of audit firms seeking to avoid the litigation risk from class action lawsuits.

The market may not be effective if it is unable to obtain sufficient information to punish firms that are exploiting conflicts of interest. To address this failure, there are four classes of interventions: (1) mandatory disclosure for increased transparency, (2) supervisory oversight, (3) separation by function, and (4) socialization of information. However, each of these remedies interferes with the combination of financial services, from which firms gain economies of scope, thereby imposing a potentially high cost on market efficiency. The most potent example of a misplaced remedy is the separation of commercial and investment banking by the Glass-Steagall Act.<sup>31</sup> The separation imposed a high cost, and only after a long struggle was the Act reversed in 1999. Market discipline that forced institutional changes on banks worked fairly well before 1929. The repeal of Glass-Steagall resulted in a move back to a greater emphasis on disclosure and oversight than was originally recommended by contemporary experts.

Mandatory disclosure to increase transparency is the least intrusive remedy. Disclosure that reveals whether a conflict of interest exists may help investors to judge how much weight to place on the information delivered by each firm. Yet, mandatory disclosure may be insufficient. Financial firms may hide relevant information and disclosure may reveal too much proprietary information. These problems suggest that the more intrusive approach—some supervisory oversight—may be needed. Supervisors can observe proprietary information about conflicts of interest without revealing it to a financial firm’s competitors and can take actions to prevent financial firms from exploiting conflicts of interest.

If the market cannot get sufficient information from disclosure or supervisory oversight is ineffective, one may contemplate the more extreme solution of enforcing the separation of financial institutions by function. Separation by function has the goal of ensuring that “agents” are not placed in the position of responding to multiple “principals” so that conflicts of interest are reduced. Moving from less stringent separation of functions (different in-house departments with firewalls between them) to more stringent separation (different

activities in separately capitalized affiliates or prohibition of the combination of activities in any organizational form) lessens conflicts of interest. Sometimes, firms may adopt these solutions independently—as did American universal banks in the 1920s—to signal that they are controlling conflicts. However, stringent separation of functions—as selected by the Glass-Steagall Act—may seriously reduce synergies of information collection, thereby preventing financial firms from taking advantage of economies of scope in information production.

The most radical response to conflicts of interest is to socialize the provision or the funding source of information. The argument for this approach is that information is a public good and so may need to be publicly supplied. Of course, the problem with this approach is that a government agency or publicly funded entity may not have the same strong incentives as private financial institutions to produce high-quality information, thus reducing the flow of essential information to financial markets. While conflicts may not be entirely prevented by mandatory disclosure and supervisory oversight, the case for separation by function or socialization of information is hard to make given the costs imposed on the financial system.

In evaluating remedies, it is important to remember that the many types of agents who provide information to the financial markets have a range of access to information. Analysts have the least access, and rating agencies have more; auditors probably have the most privileged private access followed by government regulators charged with supervisory oversight. This gradient of access to information should reflect the ability of agents to discover the true financial condition and performance of the firms that they observe. Agents' ability to discover this information will also be determined by their compensation and the other incentives provided to them.

Although these agents provide some overlapping information, one is not a substitute for another. This lack of substitution is not solely because they provide different types of information or signals to the public. These agents are all subject to various pressures and conflicts of interest that may diminish their ability to perform their task of discovery. Analysts may be well compensated and have substantial research resources at their disposal, but they may be too favorable to the firms if their bank is an underwriter and they have the least access

to proprietary information. Ratings agencies are more insulated from conflicts of interest and have better access to information, but enjoying an oligopoly, their research effort may be reduced. Auditors enjoy superior access to proprietary information and operate in a competitive industry, but the value of their opinions may be reduced by conflicts of interest and a litigation-risk-induced focus on rules rather than principles. Finally, regulators/supervisors may have the best access to proprietary information, yet their capacity to monitor is limited by the resources they have been allocated and political pressures for forbearance.

It is necessary to have multiple agents working to reduce the information asymmetries to ensure that capital markets are properly served. One group of agents may become less useful at one point in time, but maintaining the quality of information delivered by these different groups of agents engaged in overlapping work is more likely to provide sufficient monitoring of companies. Policies should be designed so that remedies increase the effectiveness of these agents rather than constrain or co-opt them.

## Notes

<sup>1</sup> This chapter is based on A. Crockett, T. Harris, F. Mishkin, and E.N. White, *infra* note 31. We analyzed four conflicts of interest in the financial services industry, but only two are discussed in detail here. This chapter is a version of “Quis Custodiet Ipsos Custodes? Controlling for Conflicts of Interest in the Financial Industry,” in Claudio Borio, William C. Hunter, George Kaufman, and Kostas Tsatsaronis, eds., *Market Discipline Across Countries and Industries* (Cambridge, Mass.: MIT Press, 2004).

<sup>2</sup> See Douglas Diamond, “Monitoring and Reputation: The Choice Between Bank Loans and Directly Placed Debt,” *Journal of Political Economy*, at 589–721 (August 1991).

<sup>3</sup> Chris Stefanadis, “Tying and Universal Banking,” Federal Reserve Bank of New York (March 2003).

<sup>4</sup> Amitabh Dugar and Siva Nathan, “The Effect of Investment Banking Relationships on Financial Analysts’ Earnings Forecasts and Investment Recommendations,” 12(1) *Contemporary Accounting Research*, at 131–60 (Fall 1995).

<sup>5</sup> See Scott E. Stickel, “Reputation and Performance Among Security Analysts,” 47 *Journal of Finance* 1811 (1992). The firms are Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, Salomon Smith Barney, and UBS Warburg.

<sup>6</sup> Debbie Galant, “Going Public,” 26(4) *Institutional Investor*, at 127 (April 1997).

<sup>7</sup> Jay R. Ritter and Ivo Welch, “A Review of IPO Activity, Pricing and Allocations,” 57(4) *Journal of Finance*, at 1795–1826 (August 2003).

<sup>8</sup> Harrison Hong and Jeffrey D. Kubik, “Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts,” 58(1) *Journal of Finance*, at 313–51 (February 2003).

<sup>9</sup> Kent L. Womack, “Do Brokerage Analysts’ Recommendations Have Investment Value?” 51(1) *Journal of Finance*, at 137–67 (March 1996).

<sup>10</sup> The predominance of buy recommendations may be the result of censoring, not over-optimism. If analysts censor by discontinuing coverage of a stock or failing to update their forecasts, then the observed average buy recommendations and earnings forecasts will be higher than the unobserved means.



<sup>11</sup> R. Michaely and K.L. Womack, “Conflict of Interest and the Credibility of Underwriter Analyst Recommendations,” 12 *Review of Financial Studies*, at 653 (1999).

<sup>12</sup> Dugar and Nathan, *supra* note 4, find additional evidence that investors are not completely fooled by optimistic analysts.

<sup>13</sup> L. Boni and K.L. Womack, “Solving the Sell-Side Research Problem: Insights from Buy-Side Professionals,” Working Paper, University of New Mexico and Tuck School of Business at Dartmouth (2002), [http://mba.tuck.dartmouth.edu/pages/faculty/kent.womack/working\\_papers/insightsprofs.pdf](http://mba.tuck.dartmouth.edu/pages/faculty/kent.womack/working_papers/insightsprofs.pdf).

<sup>14</sup> The firms are Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, Salomon Smith Barney, and UBS Warburg.

<sup>15</sup> Under the forms of the agreement, brokerage firms were no longer allowed to allocate lucrative IPO shares to corporate executives and directors positioned to greatly influence investment banking decisions.

<sup>16</sup> Sattar A. Mansi, William F. Maxwell, and Darius P. Miller, “Does Auditor Quality and Tenure Matter to Investors? Evidence from the Bond Market,” Working Paper, Virginia Tech (April 2003).

<sup>17</sup> J.E. McEnroe and S.C. Martens, “Individual Investors’ Perceptions Regarding the Meaning of U.S. and U.K. Audit Report Terminology: ‘Present Fairly in Conformity with GAAP’ and ‘Given a True and Fair View,’” 25 (3/4) *Journal of Business Finance and Accounting*, at 289–307 (April/May 1998).

<sup>18</sup> Practitioners emphasize that accounting is not a precise measurement system, and there is no system of rules that can be written to eliminate the need for judgment. See Steven M.H. Wallman, “The Future of Accounting, Part III: Reliability and Auditor Independence,” 10 *Accounting Horizons*, at 76–97 (December 1996).

<sup>19</sup> Andersen Consulting became Accenture, which had an initial public offering in 2001.

<sup>20</sup> Mohinder Parkash and Carol F. Venable, “Auditee Incentives for Auditor Independence: The Case of Non Audit Services,” 68 *The Accounting Review*, at 113–33 (1993).

<sup>21</sup> Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. See Paul Healy and James Wahlen, “A Review of the

Earnings Management Literature and Its Implications for Standard Setting,” *Accounting Horizons* (December 1999).

<sup>22</sup> Robert M. Frankel, Marilyn F. Johnson, and Karen K. Nelson, “The Relation Between Auditors’ Fees for Nonaudit Services Earnings Management,” *77 The Accounting Review*, at 71–105 (Supplement, 2002).

<sup>23</sup> Rick Antle, Elizabeth A. Gordon, Ganapathi Narayanamoorthy, and Ling Zhou, “The Joint Determination of Audit Fees, Non-Audit Fees, and Abnormal Accruals,” Yale ICP Working Paper, Yale University, No. 02-21 (2002).

<sup>24</sup> M. Defond, K. Raghunandan, and K.R. Subramanyam, “Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions,” *40 Journal of Accounting Research*, at 1247–74 (September 2002).

<sup>25</sup> Timothy B. Bell, Wayne R. Landsman, and Douglas A. Shackelford, “Auditors’ Perceived Business Risk and Audit Fees: Analysis and Evidence,” *39 Journal of Accounting Research*, at 35–44 (June 2001).

<sup>26</sup> Paul M. Healy and Krishna G. Palepu, “Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature,” *31 Journal of Accounting and Economics*, at 405–40 (September 2001); and Zoe-Vonna Palmrose, “An Analysis of Auditor Litigation and Audit Service Quality,” *63 The Accounting Review*, at 55–73 (January 1998).

<sup>27</sup> Kenneth J. Reynolds and Jere R. Francis, “Does Size Matter? The Influence of Large Clients on Office-Level Auditor Reporting Decisions,” *30 Journal of Accounting and Economics*, at 375–400 (December 2000).

<sup>28</sup> See *supra* note 24.

<sup>29</sup> Zoe-Vonna Palmrose, “Trials of Legal Disputes Involving Independent Auditors: Some Empirical Evidence,” *29 Journal of Accounting Research*, at 149–85 (Supplement 1991).

<sup>30</sup> Ronald A. Dye, “Auditing Standards, Legal Liability, and Auditor Wealth,” *101 Journal of Public Economy*, at 887–914 (December 1993).

<sup>31</sup> Andrew Crockett, Trevor Harris, Frederic Mishkin, and Eugene N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* (Geneva/London: International Center for Monetary and Banking Studies and the Center for Economic Policy Research, 2004).

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## Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921–33? A Preliminary Assessment

ARTHUR E. WILMARTH, JR.

Commercial banking organizations were leading participants in the U.S. securities markets during the great bull market of the 1920s.<sup>1</sup> Commercial banks again entered the securities markets during the 1990s, and their reentry coincided with another spectacular rise in the stock market. The stock market booms of the 1920s and 1990s were extraordinary events in U.S. economic history. As two scholars recently observed, the bull markets of 1923–29 and 1994–2000 “stand out, both in terms of their length and rate of advance in the market index . . . . [T]hese two booms were unique in character as well as magnitude.”<sup>2</sup>

The stock market crashes that followed both booms were also unparalleled. From 1929 to 1932, the total value of all common stocks listed on the New York Stock Exchange (NYSE) fell by nearly 85 percent, from US\$82.1 billion to US\$12.7 billion.<sup>3</sup> From 2000 to 2002, the value of all publicly traded U.S. stocks declined by more than 40 percent, from US\$17 trillion to US\$10 trillion.<sup>4</sup>

In both the 1920s and the 1990s, commercial banking organizations were allowed to operate as “universal banks”—that is, diversified financial conglomerates that offered banking, securities, and insurance services.<sup>5</sup> Is it merely a coincidence that the two most dramatic stock market booms and crashes in U.S. history occurred during periods when large commercial banks were major participants in the securities markets? Or did the exercise of universal banking powers contribute to the financial and economic conditions that produced both episodes? This chapter is the first installment of a longer-term project that seeks to answer these questions.

This chapter offers a preliminary assessment of the role played by universal banks in the economic boom-and-bust cycle of 1921–33. The first part reviews the successful challenge to universal banking mounted by Senator Carter Glass and other advocates of the Banking Act of 1933 (popularly known as the “Glass-Steagall Act”).<sup>6</sup> The Glass-Steagall Act emphatically repudiated the concept of “department store banking” (an early version of universal banking).<sup>7</sup> Sections 20 and 32 of the Act required commercial banks to divest the securities affiliates they had operated during the 1920s, while three other sections imposed further restrictions designed to separate banks from securities firms.<sup>8</sup>

Glass and his supporters contended that banks and their securities affiliates helped to produce an inflationary surge in the securities markets, resulting in an overproduction of securities and an unsustainable economic boom. Proponents of the Glass-Steagall Act also maintained that department store banking created conflicts of interest that prevented commercial banks from acting either as impartial lenders or as objective investment advisors. Glass and his colleagues claimed that universal banks provided excessive amounts of credit and used aggressive marketing campaigns to promote the sale of risky securities to unsophisticated investors. The Glass-Steagall Act reflected a widely shared belief that banks and their securities affiliates encouraged speculative and ultimately ruinous behavior by investors and business firms.

To evaluate the validity of these claims, the second part of this chapter examines the role of universal banks during the economic boom of the 1920s. In response to a relaxation of legal rules governing bank activities, banks greatly expanded their financing of business firms and consumers through five major channels—loans on securities, securities investments, public offerings of securities, real estate mortgages, and consumer credit. This financing surge enabled business firms and consumers to assume heavy debt burdens and to make risky investments that proved to be unviable when the U.S. economy entered a sharp recession in the summer of 1929. Many of the new investments in plant and equipment were devoted to speculative ventures that overestimated the near-term demand for products using new technologies. Supply also exceeded demand for new cars and for newly constructed residential and commercial real estate projects.

The crash of 1929 destroyed investor wealth and created great uncertainty among consumers and business firms. The business recession that began in the summer of 1929 was aggravated by the crash, and the decline in business activity exposed the hazardous levels of debt assumed by consumers and business firms during the boom years of the 1920s. Congress decided to separate banks from securities firms in 1933, based on its determination that universal banking had promoted a dangerous buildup of credit for speculative purposes.

The Glass-Steagall Act's barriers to universal banking were severely eroded by market forces and by a series of rulings issued by federal regulators and courts during the 1980s and 1990s. In 1989, federal regulators allowed bank holding companies to establish what were known as "Section 20 subsidiaries" for the purpose of underwriting debt and equity securities. By 1996, due to a progressive liberalization of the rules governing Section 20 subsidiaries, banking organizations could compete effectively with securities firms. In 1998, federal regulators allowed Travelers and Citicorp to merge, thereby creating Citigroup, the first U.S. universal bank since 1933. The creation of Citigroup placed great pressure on Congress to remove the Glass-Steagall Act's limitations on affiliations between commercial banks and securities firms.<sup>9</sup>

In 1999, Congress responded to these developments by enacting the Gramm-Leach-Bliley Act (GLBA).<sup>10</sup> GLBA repealed Sections 20 and 32 of the Glass-Steagall Act and also authorized the establishment of universal banking organizations known as financial holding companies. Under GLBA, financial holding companies may establish separate subsidiaries that engage in a full range of banking, securities, and insurance activities.<sup>11</sup>

The House and Senate committee reports on GLBA declared that the Glass-Steagall Act's restrictions on universal banking were (1) outdated in light of changing market conditions and (2) undesirable because they prevented U.S. financial institutions from providing innovative services to their customers in the most efficient manner.<sup>12</sup> The chief Senate sponsor of GLBA, Senator Phil Gramm, went even further. He denounced the Glass-Steagall Act as a misguided statute from the outset. In his view, Congress was frightened by the Depres-

sion and was driven by “demagoguery” to impose a “punitive ... artificial separation of the financial sector of our economy.”<sup>13</sup>

In claiming that the Glass-Steagall Act was an ill-conceived statute, Senator Gramm echoed the conclusions of works published by several scholars during the past two decades. As discussed in the final section of the chapter, modern scholars have criticized the Glass-Steagall Act on three principal grounds. First, critics argue that the Glass-Steagall Act was interest group legislation designed to protect traditional investment banks from competition with commercial banks in the securities underwriting field. Second, critics maintain that universal banks were safer than specialized banks and did not endanger the banking system. Third, critics claim that Congress did not have a substantial basis for its belief that universal banks were involved in unsound selling practices and other conflicts of interest.

Thus, Congress’s partial repeal of the Glass-Steagall Act in 1999 was consistent with a widely shared scholarly view that the 1933 legislation had been “[t]horoughly discredited.”<sup>14</sup> However, since the bursting of the “new economy” stock market bubble in 2000, commentators have begun to reconsider the benefits and risks of universal banking. Investigations and court suits involving Enron and WorldCom revealed that Citigroup, J.P. Morgan Chase (Morgan Chase), and other universal banks played key roles in both scandals. For example, Citigroup, Morgan Chase, and other universal banks helped Enron to inflate its reported revenues and understate its reported debts by (1) extending loans that were disguised as prepay commodity trades and (2) arranging sham sales of Enron assets to off-balance-sheet entities controlled by Enron. In addition, Citigroup, Morgan Chase, Bank of America, and other universal banks served as underwriters for two large public offerings of WorldCom debt securities during 2000 and 2001. Those offerings enabled WorldCom to sell US\$17 billion of securities to investors at a time when the bank underwriters reportedly knew that WorldCom’s financial condition was rapidly deteriorating.<sup>15</sup> Similarly, Italian authorities have alleged that Citigroup, Bank of America, and other universal banks aided and abetted a massive fraud committed by Parmalat’s managers.<sup>16</sup>

In 2003, federal regulators and the New York Attorney General, Eliot Spitzer, issued consent orders as part of a global settlement with 10 investment banking firms, including affiliates of five universal

banks (Citigroup, Morgan Chase, Credit Suisse, UBS, and U.S. Bancorp). According to those consent orders, the 10 firms encouraged their research analysts to attract and retain investment banking clients by issuing overly optimistic projections of future client performance and ignoring client risks that were known to the analysts and their investment banking colleagues.<sup>17</sup> Federal regulators also issued consent orders finding that (1) Citigroup, Credit Suisse, FleetBoston, and Morgan Chase engaged in manipulative and abusive practices involving initial public offerings,<sup>18</sup> and (2) Bank of America, Bank One, Canadian Imperial Bank of Commerce (CIBC), and FleetBoston allowed hedge fund operators to make late trades and market-timing trades in bank-sponsored mutual funds, resulting in large trading profits for the operators at the expense of ordinary investors in the mutual funds.<sup>19</sup>

The foregoing scandals and other examples of recent misconduct by universal banks will be reviewed in greater detail in a forthcoming installment of my project. These scandals have already proven to be very costly to universal banks. By August 2005, universal banks and other firms paid over US\$7 billion to settle Enron-related lawsuits, with US\$6.6 billion of that amount being paid by CIBC, Citigroup, and Morgan Chase. The same three banks paid an additional US\$400 million in penalties to settle Securities and Exchange Commission (SEC) charges related to their involvement with Enron.<sup>20</sup> Universal banks and other firms paid more than US\$6 billion to settle WorldCom-related lawsuits, with US\$5 billion of that amount being paid by Citigroup, Morgan Chase, and Bank of America. Universal banks and other firms also paid US\$4.4 billion to settle regulatory claims involving analyst conflicts of interest and abusive trading practices in mutual funds.<sup>21</sup>

In light of the growing evidence of conflicts of interest and other abuses involving universal banks during the economic boom from 1994 to 2000, several commentators have argued that federal regulators and Congress made a mistake in allowing commercial banks to establish new affiliations with securities firms. These commentators maintain that Congress underestimated the risks that (1) conflicts of interest would undermine the ability of universal banks to allocate credit and provide investment advice in an objective and impartial manner, and (2) competitive pressures in the securities underwriting



business would cause both universal banks and securities firms to promote unsound and speculative ventures.<sup>22</sup>

From a practical viewpoint, it seems very unlikely that the Glass-Steagall Act's separation between commercial and investment banking could be revived. Even before GLBA's enactment in 1999, the effectiveness of Glass-Steagall had been significantly undermined by market forces and by decisions of federal regulators and courts that opened loopholes in the 1933 statute. For example, the rapidly growing markets for over-the-counter derivatives and syndicated loans have allowed banks to provide customers with financial instruments that are functionally equivalent to securities.<sup>23</sup> However, the recent scandals involving universal banks raise serious questions about the adequacy of the regulatory structure created by GLBA. In a forthcoming article, I will consider possible reforms that could mitigate the risks currently presented by universal banks.

Accordingly, this chapter does not propose a reenactment of the Glass-Steagall Act. However, it will offer a preliminary response to the modern, three-part critique of Glass-Steagall. First, I conclude that the 1933 legislation was *not* adopted for the purpose of protecting investment banks from competition with commercial banks. Second, it appears that Congress did have a substantial basis for its belief that universal banks created serious risks for the banking system and the general economy. Third, previous scholars have determined, based on the Pecora committee's investigation in 1933, that commercial banks and their securities affiliates did engage in unsound and abusive practices. I believe that the second and third issues warrant additional research, particularly since similar abuses appeared during the 1990s when major banks reentered the securities markets.

### **Congress's Repudiation of Universal Banking in the Glass-Steagall Act of 1933**

The Glass-Steagall Act contained five provisions designed to separate commercial banks from the investment banking business.<sup>24</sup> Congress adopted these provisions based on the widely shared view that banks and their securities affiliates had played a major role in the boom and crash that occurred in U.S. securities markets and the broader economy from 1921 to 1933. As shown below, supporters of

the Glass-Steagall Act were convinced that banks and their securities affiliates had diverted credit away from sound business enterprises and, instead, promoted speculative ventures at home and abroad.

The Act's chief sponsor, Senator Carter Glass, and his principal advisor, Professor H. Parker Willis, subscribed to the "real bills doctrine." Adherents of that doctrine believed that commercial banks should restrict their operations to the acceptance of demand deposits and the extension of short-term loans to finance the production and sale of goods.<sup>25</sup> Senator Glass, Representative Henry Steagall, and other members of Congress alleged that large banks had abandoned sound banking principles during the 1920s and, instead, had promoted "stock-gambling" and an "overinvestment in securities of all kinds."<sup>26</sup> Glass, Steagall, and their supporters maintained that large banks had encouraged reckless speculation in two ways—first, by using their own funds to make excessive loans on securities and investments in securities, and second, by persuading retail investors and small correspondent banks to convert their deposits and investments in U.S. government securities into high-risk corporate, municipal, and foreign securities underwritten by bank securities affiliates.<sup>27</sup>

Thus, Congress viewed the activities of banks and their securities affiliates as a fundamental cause of the economic boom and crash that occurred during the period 1921–33. Steagall, for example, declared that the entry of banks into the securities markets produced a situation in which

[o]ur great banking system was diverted from its original purposes into investment activities, and its service devoted to speculation and international high finance... . Agriculture, commerce, and industry were forgotten. Bank deposits and credit resources were funneled into the speculative centers of the country for investment in stocks [sic] operation and in market speculation. Values were lifted to fictitious levels.<sup>28</sup>

Senator Frederick Walcott argued that this "gambling fever" and "flood tide of speculation" would never have occurred without the credit and distribution facilities provided by large banks and their securities affiliates. In Walcott's view, traditional investment banking firms like J.P. Morgan and Kuhn Loeb could never have arranged and financed the rapid expansion in securities underwriting, trading, and

selling that took place during the 1920s. Such an expansion required much broader distribution capabilities and “very expansive credit, which, of course, brought in the banks.” As for bank securities affiliates, “their growth has been phenomenal, coincident with the growth of the security business.”<sup>29</sup>

Representative Hamilton Fish agreed that large banks and their securities affiliates were primarily responsible for the speculative “inflation” that led to the Crash of 1929 and the Great Depression:

[T]hese bank presidents ... got us into this inflation largely through these securities affiliates connected with the big banks. ...

All the time they were saying to their depositors, “You have got money in our banks, and you ought to take it out of our banks and invest it.” ... Those securities affiliates did more harm in promoting the inflation and the resulting deflation that caused the financial ruin of hundreds of thousands of bank depositors than any other agency in America. ...

There was an enormous inflation brought about because of the mass overproduction of stocks, bonds, and other securities largely emanating from these affiliates, ... and as a result it meant a mass overproduction of factories, commodities, real estate, and everything else—an enormous inflation that sooner or later had to crash. ...<sup>30</sup>

While noting the dangers of speculation, Senator Robert Bulkley focused on conflicts of interest that were created by affiliations between banks and securities dealers. In Bulkley’s view, a bank connected with a securities affiliate could not provide fair and impartial investment advice to its depositors and its trust customers, because the bank had a vested interest in promoting securities that were underwritten or distributed by the affiliate. Nor could such a bank be expected to make objective lending decisions, because it would be tempted to make unsound loans to support its securities affiliate or the customers of that affiliate.<sup>31</sup> Bulkley explained that

the greatest protection to depositors that we have given in [the Glass-Steagall Act] is ... [by] prohibiting a banker from having an interest contrary to his depositors, by prohibiting

him from being interested in securities which he recommends his depositor to buy, by ... removing the bankers from the temptation of using credit in such a way as to make a good background and foundation for the flotation [of] more security issues. ...<sup>32</sup>

Similar concerns about conflicts of interest were expressed in a 1931 staff report prepared by a Senate subcommittee during hearings on the securities activities of banks. This report identified a number of potential dangers created by affiliations between banks and securities dealers, including the following:

(i) the bank might make risky loans or capital contributions to a securities affiliate, particularly as “[t]he bank is closely connected in the public mind with its affiliates, and should the latter suffer large losses it is practically unthinkable that they would be allowed to fail”;<sup>33</sup>

(ii) the bank could purchase stock from a securities affiliate to “relieve the affiliate of excess holdings”;<sup>34</sup>

(iii) the bank could make risky loans to a securities affiliate’s customers in order to “facilitate” the affiliate’s distribution of securities;<sup>35</sup>

(iv) a securities affiliate might try to support the market price of the bank’s stock by using aggressive or manipulative trading practices;<sup>36</sup>

(v) a securities affiliate might consider the bank’s depositors as “its preferred list of sales prospects,” and the depositors’ confidence in the bank would be severely shaken if they lost money after purchasing securities that were underwritten or distributed by the affiliate;<sup>37</sup> and

(vi) in general, the bank and its securities affiliate would be tempted to take greater risks because of their assumption that (a) the affiliate could rely on the “resources of the bank” and (b) the bank could remove poorly performing loans or investments from its balance sheet by transferring them to its affiliate.<sup>38</sup>

As discussed in this chapter, the Senate investigation led by Ferdinand Pecora in 1933 focused much of its attention on alleged conflicts of interest involving large banks and their securities affiliates.

During Senate hearings in 1931 and Senate floor debates in 1932, participants frequently mentioned two major financial conglomerates—Caldwell and Company and Bank of United States—that collapsed during the autumn of 1930.<sup>39</sup> As discussed below, both organizations controlled securities subsidiaries that engaged in risky activities and relied heavily on loans provided by affiliated banks.<sup>40</sup> During final deliberations on the Glass-Steagall Act in 1933, members of Congress also commented on the recent failures of four large Detroit and Cleveland banks. All four banks had securities affiliates, and the failures of those banks helped to precipitate a nationwide banking panic culminating in President Roosevelt’s declaration of a national bank holiday in March 1933.<sup>41</sup>

Commercial banks and the Hoover administration strongly opposed Senator Glass’s proposed legislation in 1931 and 1932 and were successful in preventing its passage. However, the election of President Franklin Roosevelt and a heavily Democratic Congress in November 1932 greatly increased the political leverage held by Glass and his supporters. Glass himself made a nationwide radio address on Roosevelt’s behalf in the closing days of the 1932 campaign. In that speech, he condemned the “great banking institutions” for having used their “lawless affiliates” to sell worthless securities to American investors. During the spring of 1933, commercial banking interests lost all remaining power to block the Glass bill, due to the devastating impact of the nationwide banking panic and the public outrage triggered by the Pecora committee’s investigation of bank securities affiliates. In addition, many banks voluntarily decided to shut down their securities affiliates, because they could not afford to absorb the affiliates’ expenses and losses.<sup>42</sup> Consequently, effective opposition to the Glass bill virtually disappeared and Congress passed the Glass-Steagall Act on June 16, 1933.<sup>43</sup>

### **The Role of Banks in the Boom-and-Bust Cycle of 1921–33**

As shown in the preceding section, the Glass-Steagall Act reflected Congress’s belief that commercial banks and their securities affiliates helped to generate an unsustainable economic boom during the late 1920s. Senator Glass had no doubt on this score, arguing that bank securities affiliates “were the largest contributors, next to the

gambling on the stock exchange, to the disaster which was precipitated on this country in 1929.”<sup>44</sup> The conclusions of Senator Glass and his supporters rested in part on the fact that the stock market boom of the 1920s coincided with the rapid expansion of bank involvement in the securities markets:

[F]rom just a common-sense, cause-and-effect standpoint, one could easily make a formidable argument against the security affiliate system. No sooner had [banks become major participants in the securities markets] than the great bull market had gotten under way! During the period from 1928 through 1930, commercial banks had substantially increased their market share of the new bond issues and had begun to make inroads into the equity market. No matter what significance one might give that development today, certainly to the national legislators of the early 1930s the probable correlation must have made a strong impression. This was particularly true of a financial “purist” like Carter Glass.<sup>45</sup>

As described in this section, banks contributed to the economic boom of the late 1920s through five different channels—loans on securities, securities investments, public offerings of securities, real estate lending, and consumer credit. All of these channels generated a surge of new financing, which greatly increased the debt burdens of business firms and consumers and encouraged speculative investments by both groups.

## **Banks Became Leading Participants in the Securities Markets During the 1920s**

### ***The Rapid Expansion of Bank Securities Activities***

During the decade preceding the stock market crash, banks greatly expanded their involvement in the securities markets in three areas: (1) making loans collateralized by securities (known as “loans on securities” or “security loans”), (2) making investments in securities, and (3) participating in the underwriting and distribution of securities. Bank loans on securities increased from US\$5.2 billion to US\$13 billion between 1919 and 1930. As a result, the share of total bank credit represented by security loans rose from 24 percent to

38 percent during that period. Banks accounted for more than 85 percent of all loans on securities made from 1919 to 1930.<sup>46</sup>

Bank investments in securities grew from US\$8.4 billion to US\$13.7 billion between 1921 and 1930. Four-fifths of this growth resulted from purchases of higher-risk issues, including state and municipal bonds, corporate bonds, and foreign securities. As a consequence, holdings of low-risk U.S. government securities declined from 35 percent to 26 percent of bank investment portfolios during the same period.<sup>47</sup>

Large banks also established a major presence in the securities underwriting business. The entry of banks into the underwriting business marked the final stage in the expansion of bank securities activities during the 1920s. During the early 1900s, the Comptroller of the Currency (the regulator of national banks) informally permitted national banks to establish bond departments so that they could compete with the investment banking activities conducted by state-chartered banks and trust companies. Through their bond departments, national banks actively bought and sold bonds issued by state and local governments and by domestic corporations. The McFadden Act of 1927 ratified the legitimacy of these bond departments, because the statute authorized national banks to buy and sell marketable debt securities.<sup>48</sup>

Neither the original National Bank Act nor the McFadden Act allowed national banks to underwrite securities or to invest in equity stocks.<sup>49</sup> However, beginning in 1908 national banks circumvented this limitation on their authority by organizing separately incorporated securities affiliates that engaged in a full range of underwriting, distribution, and dealing activities involving both bonds and stocks. Prior to the Great Depression, neither Congress nor federal regulators interfered with the activities of bank securities affiliates.<sup>50</sup>

Political and economic developments encouraged banks to expand their involvement in securities underwriting and distribution after 1920. During World War I, the federal government enlisted banks as major participants in the selling campaigns for the government's war bonds, known as "Liberty Loans." More than 20 million Americans bought Liberty bonds, and banks sold more than half of the US\$21 billion of Liberty bonds issued by the federal government.<sup>51</sup> By participating in the Liberty bond campaigns, banks be-

came “familiar with the technique of distributing securities [and] gained many contacts with investors and won their confidence, partly because of their patriotic mission, partly because they offered bonds of unquestioned soundness.”<sup>52</sup>

One of the leaders of the Liberty bond effort, Charles Mitchell, became president of the securities affiliate of National City Bank (NCB) in 1916 and became president of the Bank itself in 1921. Mitchell predicted that sales of Liberty bonds would create “a large, new army of investors in this country who have never heretofore known what it means to own a coupon bond and who may in the future be developed into savers and bond buyers.”<sup>53</sup> As Mitchell expected, the successful Liberty bond campaigns helped to stimulate a rapid growth in investor demand for corporate bonds and stocks during the economic boom of the 1920s. Politicians, economists, and financial analysts also promoted investor confidence in securities by proclaiming that the U.S. economy had entered a new era of permanent prosperity. Belief in this “new era” was based on several factors:

The first premise of the “new economics,” as [the new era] was otherwise called, was that the business cycle ... had been effectively abolished by the establishment of the Federal Reserve System in 1913. ... The Federal Reserve, with its ability to control interest rates and conduct “open market operations” ... was hailed in the 1920s as “the remedy to the whole problem of booms, slumps, and panics.” ...

Alongside the belief in the omnipotence of the Federal Reserve, a variety of additional explanations were offered for the endurance of the “Coolidge prosperity” which had commenced with the election of President Calvin Coolidge in 1924. ... They included the extension of free trade, the decline of inflation, and a more scientific style of corporate management. ...

The relaxation of the antitrust laws during Coolidge’s presidency allowed for a series of mergers of banking, railroad, and utility companies that promised greater economies of scale and more efficient production. Gains in productivity, which rose by over 50 percent between 1919 and 1927, were ascribed to increasing investment in research and development. ...



In 1927, John Moody, founder of the credit ratings agency, declared that “no one can examine the panorama of business and finance in America during the past half-dozen years without realizing that we are living in a new era.” In April of that year *Barron’s*, the investment weekly, envisaged a “new era without depressions.” ... Even Herbert Hoover’s acceptance speech in the summer of 1928, when he declared the end of poverty to be in sight, was marked by the prevailing “new era” optimism.<sup>54</sup>

Faith in this new era of risk-free prosperity encouraged a spectacular growth of the securities markets during the 1920s.<sup>55</sup> A financial writer declared in 1924 that “[w]e are living in the day of the small investor, and the small investor is the real owner of Wall Street.”<sup>56</sup> Commercial banks had been the primary providers of credit to large corporations before 1920. During the 1920s, however, growing investor demand for securities permitted large corporations to reduce their borrowing from banks and to satisfy their funding needs by selling bonds and equity stocks.<sup>57</sup> Large firms used public offerings of securities to finance extensive new corporate investments in plant facilities, equipment, and office buildings.<sup>58</sup> A 1925 report by *Moody’s Investors Service* noted that the “vast new buying power [of American investors and businessmen] is almost dominating the security market ... and is seeking new avenues of expansion in all domestic industries and in foreign fields.”<sup>59</sup>

In response to these developments, major banks expanded their investment banking activities in order to maintain and strengthen their relationships with retail and commercial customers. Banks sought to increase the loyalty of their retail customers by providing investment advice and by selling securities to their depositors and trust clients. Banks also hoped that securities underwriting services would offset the decline in their commercial lending business and strengthen their business relationships with large corporations.<sup>60</sup> Major banks therefore adopted a new strategy of “department store banking” designed to offer “complete financial facilities” to both retail and commercial customers.<sup>61</sup>

From 1922 to 1929, the number of banks engaged in underwriting securities, either through bond departments or securities affiliates, more than doubled, rising from 277 to 591.<sup>62</sup> In 1927, banks and their affiliates originated 22 percent and participated in 37 percent of all domestic and foreign bonds issued in the United States. From 1929 to 1930, banks and their affiliates originated 45 percent and participated in more than half of all such bond issues.<sup>63</sup> Banks were also involved to a lesser degree in underwriting and distributing common and preferred stocks and shares of investment trusts.<sup>64</sup>

NCB and Chase National Bank (Chase), the two largest U.S. banks, established securities affiliates with offices located across the nation and in major foreign cities. NCB's affiliate, National City Company (NCC), was organized in 1911 and acquired N.W. Halsey and Company in 1916. By 1929, NCC operated offices in more than 50 U.S. cities and several foreign cities, and NCC's sales representatives were also posted in many of NCB's foreign branches.<sup>65</sup> Chase's affiliate, Chase Securities Corporation (CSC), was organized in 1917 and acquired Harris Forbes & Co. in 1930, thereby establishing a similar network that included offices in more than 50 U.S. cities and several foreign cities.<sup>66</sup> Other large U.S. banks sought to compete by establishing securities affiliates with interstate sales offices. Like NCC and CSC, these affiliates often expanded by acquiring established investment banking firms.<sup>67</sup>

### ***The Role of Banks in Promoting the Stock Market Boom***

By the end of the 1920s, due to their central role in distributing securities to the public, "commercial banks [were] by far the most important element in the investment banking business."<sup>68</sup> Commercial banks and their affiliates distributed more than half of all securities sold in the United States during the period from 1927 to 1931, and NCC was the largest retail distributor of securities during that period.<sup>69</sup> From 1921 to 1929, NCC was involved, as originator or as a syndicate participant, in selling one-fifth of all domestic and foreign bonds issued in the United States.<sup>70</sup>

Contemporary observers concluded, and modern scholars agree, that the securities boom of the 1920s could not have reached the same magnitude without the involvement of large commercial banks and their securities affiliates. For several reasons, major banks were in a

preferred position to establish large-scale networks for distributing securities. Banks could easily extend loans to facilitate the sale of securities by drawing upon their deposits. In addition, banks could cultivate their close relationships with corporate issuers, and they could mobilize a large customer base that included depositors, trust customers, and small correspondent banks.<sup>71</sup> The securities distribution facilities of banks and their affiliates were indispensable to the syndicate operations of the 1920s, because “the sales staffs and capital of existing private investment banking firms were not adequate to handle the great volume of securities being issued.”<sup>72</sup>

NCC became a top securities underwriter based on the unrivaled “placing power” provided by its retail distribution system. NCC maintained close relationships with J.P. Morgan and Kuhn, Loeb, which led more than half of the syndicates in which NCC participated during the period from 1921 to 1929. The Morgan and Kuhn, Loeb firms relied heavily on NCC’s distribution network, because they had “no retail distribution [facilities] of their own.”<sup>73</sup>

Under Charles Mitchell’s leadership, NCC developed a highly sophisticated program of mass advertising and direct marketing that was carefully designed to sell securities to middle-income investors. As already noted, NCC maintained a far-flung network of offices staffed by hundreds of sales representatives.<sup>74</sup> Its headquarters office sent out a steady stream of “flashes” to its regional offices containing investment recommendations and offers of cash prizes and other incentives for good performance by sales representatives.<sup>75</sup> Mitchell declared that NCC’s goal was to “spread the gospel of thrift and saving and investment” and to “bring the investment banking house to the people in such a way that they would look upon it as a part and parcel of their everyday life.”<sup>76</sup>

NCC also advertised extensively in national magazines. NCC’s advertisements “assured prospective customers that if they saved, it would advise them how to invest.”<sup>77</sup> For example, one of NCC’s magazine advertisements advised customers that

... the investor should not try to decide alone. He can get the considered opinion of a world-wide investment organization—it is his for the asking. [NCC’s] judgment as to which

bonds are best for you is based on both strict investigation of the security and analysis of your own requirements.<sup>78</sup>

Mitchell explained to his employees that NCC's goal was to win the confidence of small investors and to convince them that they should rely on NCC's recommendations. Mitchell readily admitted that the ordinary investor could not be expected to make informed decisions. He therefore acknowledged that NCC owed a duty of trust to its retail customers:

We have gained the confidence of the investor and we are building our institution upon that confidence. We want the public to feel safe with us. We are going to make more exacting our yard-stick, because the small investor who buys from us today a thousand or five hundred dollar bond is not in a position to know whether that security is good or not and must rely on us. ... [W]e recognize that as between ourselves and this small investor, the law of *caveat emptor* cannot apply, and that if we are to fulfill our trust, we must supply that which means safety and a reasonable return to him.<sup>79</sup>

Unfortunately, Mitchell's recognition of NCC's duty of trust to its customers seemed to disappear whenever NCC needed to achieve its sales objectives. In one sales flash he warned sales representatives:

I should hate to think there is any man in our sales crowd who would confess to his inability to sell at least some of any issue of either bonds or preferred stock that we think good enough to offer. In fact, this would be an impossible situation and in the interest of all concerned, one which we would not permit to continue.<sup>80</sup>

Mitchell and NCC were successful in winning the trust of small investors during the 1920s. By 1929, NCC was the "largest distributor of securities in the world," while its affiliate, NCB, was the "largest bank in the country ... and was challenging Britain's Midland Bank for the position of largest bank in the world."<sup>81</sup> Along with J.P. Morgan, Jr., Mitchell and Albert Wiggin (president of Chase) were "leading social, political, and economic figures ... [who were] followed in the newspapers like movie stars or politicians."<sup>82</sup> Critic Edmund Wil-

son described Mitchell as “the banker of bankers, the salesman of salesmen, the genius of the New Economic Era.”<sup>83</sup>

Mitchell and Wiggin viewed themselves as guardians of the stock market, and they vigorously advocated the benefits of bank securities affiliates. Mitchell responded aggressively when the stock market weakened and interest rates on brokers’ call loans rose sharply in March 1929. Market participants feared that call loans might soon be scarce, because the Federal Reserve Board was pressuring banks not to provide credit for speculation in the stock markets. Mitchell stabilized the stock market by publicly announcing that NCB would make available up to US\$25 million in new call loans. He declared that “we have an obligation which is paramount to any Federal Reserve warning, or anything else, to avert any dangerous crisis in the money market.”<sup>84</sup>

Similarly, on October 15, 1929, Mitchell tried to reassure investors by stating publicly that “[t]he markets generally are now in a healthy condition ... [and] values have a sound basis in the general prosperity of our country.”<sup>85</sup> When the Great Crash began in earnest nine days later, Mitchell, Wiggin, and other leading Wall Street bankers organized a publicly announced pool to support the stock market by purchasing pivotal stocks. However, the bankers’ pool could not arrest the steady slide of the stock market, and the bankers were shown to be powerless by October 29th.<sup>86</sup>

John Kenneth Galbraith has observed that “[f]ew men ever lost position so rapidly as did the New York bankers in the five days from October 24 to October 29.”<sup>87</sup> During the 1931 Senate hearings, Wiggin asserted that “[t]he whole country is stock-minded ... [and] are waiting for a rebound to-day,” but his optimism seemed hollow.<sup>88</sup> During the same hearings, Wiggin, Mitchell, and other leading bank executives strongly opposed Senator Glass’s proposal to separate commercial banks from their securities affiliates. Wiggin argued that securities affiliates provided “an essential banking service in financing the large corporations ... and other clients of the banks.”<sup>89</sup> Mitchell disputed Senator Walcott’s suggestion that securities affiliates of banks had contributed to the “increase in public credence [sic] or gullibility” and had helped to generate a “whirlpool of speculation” in the securities markets. Mitchell claimed that “[t]he investment bankers of the country are not the framers of public opinion.

They must yield to the will of the investing public.”<sup>90</sup> Mitchell’s description of Wall Street bankers as the submissive servants of public opinion contrasted sharply with his lecture to NCC’s employees 12 years earlier, when he declared that NCC must spread “the gospel of thrift and saving and investment” and “bring the investment banking house to the people.”<sup>91</sup>

The public influence of Wiggin and Mitchell was already waning in 1931 and was completely destroyed by the Pecora committee’s investigation in 1933. Mitchell and Wiggin were personally disgraced and resigned as bank officers. NCB and Chase voluntarily decided to divest their securities affiliates in March 1933, even before Congress enacted the Glass-Steagall Act.<sup>92</sup>

## **Bank Involvement in the Securities and Credit Markets Helped to Produce an Unsustainable Economic Boom During the 1920s**

### ***The Role of Banks in the Financing Boom***

The rapid expansion of bank securities activities during the 1920s helped to generate an unprecedented boom in the securities markets. From 1919 to 1929, U.S. corporations issued US\$49 billion of securities, including US\$19.5 billion of stocks and US\$29.5 billion of bonds and notes. Annual offerings of corporate securities more than tripled during this period, rising from US\$2.7 billion in 1919 to US\$9.4 billion in 1929.<sup>93</sup> State and local governments issued more than US\$14 billion of debt securities during the 1920s, with the majority of that amount being sold during the second half of the decade.<sup>94</sup> Foreign governments and foreign corporations sold US\$11 billion of securities to U.S. investors between 1919 and 1929, with the largest amounts being offered during the period 1924 to 1928.<sup>95</sup> As indicated by these figures, all types of securities were issued in much greater volumes as banks and their affiliates expanded their role in the securities markets during the second half of the 1920s.

The extraordinary boom in the securities markets was also manifested by dramatic increases in trading volumes and price levels. Annual trading volume on the NYSE more than quadrupled during the 1920s, rising from 230 million shares in 1920 to 1.1 billion shares in 1929.<sup>96</sup> The Dow Jones Industrial Average (DJIA) recorded a sixfold

increase, rising from 64 in August 1921 to 381 in September 1929. The price-earnings ratio for the Standard & Poor's Composite Index of stocks also rose by a factor of six during the 1920s and reached 32.6 in September 1929, a record that endured until the great bull market of the 1990s reached its peak in early 2000.<sup>97</sup>

Economists have concluded that the stock market boom produced a speculative bubble during 1928 and 1929.<sup>98</sup> Those are the same two years during which (1) commercial banks and their affiliates recorded the most rapid growth in their securities underwriting and retail sales activities, and (2) Wall Street investment banking firms responded by selling units in hundreds of investment trusts (forerunners of today's mutual funds) to small investors.<sup>99</sup> Mass-marketing techniques used by bank securities affiliates and by investment trusts attracted large pools of investment funds from middle-class individuals who had largely avoided the securities markets before 1920. This huge infusion of retail investor funds produced a spectacular growth in the total financing made available to U.S. corporations. One-third of all debt and equity securities issued by domestic companies from 1919 to 1929 were sold during the last two years of that period. Thus, the entry of commercial banks into the securities markets triggered an intense rivalry with securities firms, resulting in an overissue of new securities that contributed to the speculative bubble of 1928–29.<sup>100</sup>

The existence of a bubble in the securities markets is further indicated by the stunning declines in stock and bond values, and the significant increases in bond defaults, following the Crash of 1929. Between September 1929 and July 1932, the DJIA fell from 381 to 41 and the aggregate value of all NYSE-listed stocks declined from US\$82.1 billion to US\$12.7 billion.<sup>101</sup> More than a quarter of all domestic bonds issued during the 1920s defaulted during the 1930s, and default rates were particularly high for domestic bonds issued after 1926.<sup>102</sup> Market values declined significantly even for those domestic bond issues that did not default during the 1930s.<sup>103</sup> Purchasers of foreign bonds suffered the worst losses. More than a third of all foreign bonds sold to U.S. investors during the 1920s had defaulted by 1937, including three-quarters of all bonds sold by Eastern European and Latin American issuers.<sup>104</sup>

### ***The Expansion of Bank Real Estate Loans and Consumer Credit***

In addition to their rapidly growing involvement in the securities markets, commercial banks greatly expanded their real estate lending activities after World War I. Between 1913 and 1927, Congress passed statutes that significantly broadened the authority of commercial banks to make loans secured by real estate.<sup>105</sup> Bank real estate loans more than tripled from 1919 to 1929, with most of those loans being made in urban markets.<sup>106</sup> The rapid growth of bank real estate lending was part of a broader trend. Between 1919 and 1930, the total amount of U.S. nonfarm mortgage debt rose from US\$8 billion to over US\$30 billion. Banks, savings institutions, and life insurance companies held more than US\$24 billion of this debt, while the remaining US\$6 billion was held in the form of real estate bonds secured by mortgages on apartment buildings and office buildings. Commercial banks held about US\$5.5 billion of real estate loans and bonds on their balance sheets in 1930.<sup>107</sup>

The dramatic growth of real estate financing during the 1920s fueled a spectacular real estate boom that mirrored the bull market in securities. From 1921 to 1929, more than US\$75 billion was expended on private and public construction projects, including almost US\$35 billion spent in building new housing units. Urban real estate values doubled during the same period. Construction of detached, one- to four-family homes declined after 1926, but construction of new apartment buildings and office buildings continued at a rapid pace until 1929.<sup>108</sup> As the Senate Banking Committee observed in 1933, the “immense increase in the volumes of real-estate bond issues and of real-estate mortgages both in banks and [other] financial institutions” created a speculative boom that resulted in many “overbuilt” urban real estate markets by 1929.<sup>109</sup>

In addition to funds from newly issued securities and real estate loans, a third source of new financing during the 1920s was the growth of consumer nonmortgage credit. From 1919 to 1929, consumer installment debt rose from US\$1.9 billion to US\$4.9 billion and total consumer nonmortgage debt increased from US\$2.9 billion to US\$7.6 billion. Expanded consumer credit allowed Americans to buy vast quantities of cars, radios, phonographs, household appliances, furniture, jewelry, and other durable consumer goods. Postwar consumer purchases of durable goods were spurred by (1)



pent-up demand that could not be satisfied during the economic austerity of World War I, (2) increases in disposable income created by a decade of prosperity, and (3) improvements in convenience and entertainment offered by a wide range of new consumer products. For example, car registrations rose from 11 million to 26 million between 1921 and 1929, and automobile loans were the single largest source of consumer installment credit. Nonmortgage consumer credit was offered to consumers by manufacturers, merchants, consumer finance companies, and some commercial banks (including NCB). In addition, commercial banks provided most of the indirect financing for nonmortgage consumer credit by purchasing consumer installment notes or by making loans to manufacturers, merchants, and finance companies.<sup>110</sup>

### ***The Vulnerability of the U.S. Economy to a Severe Economic Downturn in 1929***

As shown in the preceding section, commercial banks participated in the financing boom of the 1920s through five different channels—loans on securities, securities investments, public offerings of securities, real estate lending, and consumer credit. The financing boom of the 1920s created two conditions that contributed to the onset and severity of the Great Depression. First, abundant credit allowed both the private and public sectors to assume heavy debt burdens, resulting in a national economy that was extremely fragile at the end of the 1920s. By 1929, total private and public debt probably exceeded US\$200 billion, with more than 80 percent of that amount being owed by private firms and individuals. This aggregate debt burden was more than double the nation's total annual income of US\$87 billion. Total debt service as a percentage of gross domestic product (GDP) rose to 9 percent for the United States in 1929, compared to only 3.9 percent for Canada.<sup>111</sup> This highly leveraged situation exposed consumers, state and local governments, and business firms to devastating financial shocks during the Great Depression.<sup>112</sup>

Second, the explosion of debt and equity finance during the 1920s encouraged excessive investments in real estate, industrial plant and equipment, and public facilities. From 1921 to 1929, almost US\$35 billion was invested in new housing, US\$55 billion was spent for new plant facilities and equipment, and at least US\$10 billion was

expended by public agencies for roads, schools, and public utilities.<sup>113</sup> Industrial production increased by 40 percent from 1922 to 1929, reflecting large investments in new manufacturing facilities.<sup>114</sup>

Many of the housing subdivisions, apartment buildings, and office buildings constructed during the 1920s proved to be poorly planned and economically unviable when the real estate boom ended.<sup>115</sup> Similarly, much of the new investment in plant and equipment was committed to speculative and ultimately unsuccessful ventures. Many high-flying companies of the 1920s were relatively young firms, which tried to exploit new technologies that had captured the imagination of Wall Street bankers and individual investors. The most fashionable and speculative stocks of the 1920s were issued by companies involved with aircraft, automobiles, chemicals, electrical equipment and appliances, electrical utilities, motion pictures, phonographs, radios, and retail stores. Du Pont, Fox Films, General Electric, General Motors, Montgomery Ward, Radio Corporation of America, RKO, United Aircraft and Transport, and Westinghouse were notable examples of the glamour stocks of the 1920s.<sup>116</sup>

Many younger firms in high-tech businesses failed during the 1920s or subsequently during the Depression, resulting in significant losses in both investment value and productivity. Those failures were consistent with a typical pattern of industrial development in which (1) numerous firms enter a new field with plans to exploit an emerging technology; (2) a highly competitive shakeout period ensues, resulting in the failure or absorption of most entrants; and (3) the industry evolves into a more stable oligopoly dominated by a few leading firms.<sup>117</sup> For example, despite the tremendous increase in automobile production and sales during the 1920s, the number of car manufacturers declined from 104 to 30 and the number of automobile tire producers fell from 274 to 93 during the same decade.<sup>118</sup> Similarly, Wall Street bankers and investors poured too much financing into radio, motion pictures, and other high-tech industries based on unrealistic expectations of how quickly those fields would produce steady growth and solid profits.<sup>119</sup> Markets for automobiles, radios, and other high-tech goods were saturated by the end of the 1920s, as indicated by the rapid growth of business inventories during 1929.<sup>120</sup>

The stock market bubble of 1928–29 produced a final burst of new investment funds for the U.S. economy. U.S. corporations issued US\$16.3 billion of bonds and stocks during those two years, accounting for one-third of all domestic corporate securities issued between 1919 and 1929. As previously noted, bank securities affiliates and investment trusts were instrumental in finding purchasers to absorb this huge volume of new securities.<sup>121</sup> The final stage of the stock market boom encouraged many business firms to make speculative investments in commercial real estate and industrial facilities. Construction of apartment buildings, office buildings, and plant facilities rose sharply in 1928–29, along with investments in business equipment and inventories. It appears that the financing surge of 1928–29 induced firm managers to make costly new investments based on their expectation that demand would continue to grow in line with the boom years of 1924–28.<sup>122</sup>

Unfortunately, the rosy expectations fueled by the stock market bubble proved to be unfounded. The U.S. economy began to weaken in the summer of 1929, as both construction activity and automobile production declined.<sup>123</sup> Consumption of durable goods by consumers plummeted following the crash of 1929, leading to a sharp drop in business investments in plant, equipment, and inventories. As a consequence, GDP declined by 10 percent and industrial output fell by 21 percent during the period 1929–30.<sup>124</sup> In view of the rapid declines in consumer consumption, industrial output, and business investment of 1929–30, it seems clear that the crash of 1929 triggered a severe economic downturn by (1) destroying investor wealth; (2) creating uncertainty among investors, consumers, and business managers; and (3) disrupting the stock market's ability to serve as a channel for continued financing.<sup>125</sup>

To sum up, commercial banks were leading participants in the expansion of debt and equity financing during the 1920s. The surge of new financing fueled a speculative economic boom that encouraged consumers and business firms to assume heavy debt burdens and to make speculative investments. The boom left the U.S. economy in an extremely fragile condition at the end of 1929.<sup>126</sup>

Commercial banks and other financial institutions were not solely responsible for the boom-and-bust cycle of 1921–33. The Federal Reserve’s decisions on monetary policy played a major role in both the boom and the collapse. A detailed analysis of the Federal Reserve’s actions during 1921–33 is beyond the scope of the present discussion. However, I will note three aspects of the Federal Reserve’s policy that have been heavily criticized by both contemporary and modern scholars.

First, the Federal Reserve adopted “easy-money” policies in 1924 and 1927, thereby encouraging the financing boom that continued through late 1929. In 1924 and again in 1927, the Federal Reserve cut the discount rate and purchased large amounts of government securities. Both episodes were motivated by domestic and foreign considerations. The Federal Reserve wanted to reduce interest rates to counteract mild downturns in the U.S. economy that occurred in 1924 and 1927. In addition, the Federal Reserve wanted to help the United Kingdom, France, and Germany in their efforts to reestablish the gold standard in 1924–25, and to preserve the gold standard in 1927. By producing easier credit conditions, the Federal Reserve’s policy actions in 1924 and 1927 supported the securities markets and helped to extend the nation’s economic prosperity. Unfortunately, the Federal Reserve’s actions also encouraged speculative behavior. The Federal Reserve’s apparent ability to fine-tune the economy and sustain the postwar boom led many financial institutions, investors, and business firms to believe that the business cycle had been tamed.<sup>127</sup>

The Federal Reserve’s second error was to pursue an overly restrictive monetary policy in 1928–29. The Federal Reserve wanted to curb excessive speculation in the securities markets, but its actions had the unintended effect of increasing the real cost of credit for the general economy. Tight credit conditions, particularly in view of the continuing demand by investors for security loans, precipitated a sharp economic downturn in the summer of 1929.<sup>128</sup>

The Federal Reserve’s third (and most fateful) mistake was that it failed to counteract the destabilizing effects of a series of regional banking panics, which began in late 1930 and culminated in the nationwide banking holiday of March 1933. The banking panics produced a severe contraction in the nation’s money supply by freezing

the deposits held by failed banks and by encouraging depositors in open banks to convert their deposits into currency. Bank failures also depressed economic activity by disrupting the flow of credit to businesses, especially small and medium-sized firms that could not obtain financing through the securities markets. The Federal Reserve failed to make sustained, large-scale purchases of government securities and bank acceptances in order to offset declines in the nation's money supply. In addition, the Federal Reserve did not act as lender of last resort for the banking system. Many economists believe that the Federal Reserve's failure to respond to the progressive collapse of the banking system turned the sharp recession of 1929–30 into the Great Depression of 1931–33.<sup>129</sup>

The Federal Reserve's policy mistakes were important factors that help to explain the intensity of the speculative boom of the 1920s and the severity of the economic collapse of the early 1930s. Senator Glass himself assigned much of the blame to the Federal Reserve.<sup>130</sup> At the same time, there is substantial support for Glass's claim that banks and their securities affiliates bore significant responsibility for the boom-and-bust cycle of 1921–33. Contemporary scholars and members of Congress pointed out that banks and their affiliates played key roles in arranging the debt and equity financing that fueled the economic boom of the 1920s. Contemporary observers also stressed the linkage between the abundant financing of the 1920s and the leverage and overinvestment that aggravated the economic collapse of the 1930s.<sup>131</sup>

Two recent studies provide additional evidence supporting Senator Glass's view. Eichengreen and Mitchener documented the existence of a credit boom in the United States and several other countries during the second half of the 1920s. They also determined that this credit boom contributed to the economic slump of the 1930s, particularly in nations (like the United States) in which the credit boom was accompanied by a stock market boom.<sup>132</sup>

Cole, Ohanian, and Leung found that productivity shocks accounted for about two-thirds of the output changes in 17 countries during 1929–33, while monetary/deflation shocks accounted for the remaining third. Consequently, they concluded that productivity shocks were more important than monetary factors in explaining the

collapse of economic output during the Great Depression. They also determined that productivity shocks during 1929–33 were linked to industrial activity and were expected by stock market investors to persist throughout the period. Finally, they found some support for the view that productivity shocks were correlated with financial market shocks, including banking panics.<sup>133</sup> The findings of both studies are broadly consistent with the understanding of Glass and his supporters. As discussed earlier, Glass and his colleagues maintained that excessive debt and equity financing during the 1920s generated overinvestment and economic fragility, resulting in a collapse of economic output when the sources of that financing were disrupted by the Crash of 1929.

### **A Preliminary Reconsideration of the Modern Critique of the Glass-Steagall Act**

Beginning in the 1980s, a number of scholars have argued that the Glass-Steagall Act was an ill-conceived law from the outset. These critics have raised three principal points. First, they contend that the Glass-Steagall Act was self-interested legislation that was promoted by traditional investment banks in order to expel commercial banks from the securities underwriting business. Second, they maintain that banks with securities affiliates were safer institutions and were more likely to survive the banking panics of the 1930s, in comparison with specialized commercial banks. Third, they contend that Congress was largely mistaken in its belief that universal banks had endangered the public interest through abusive selling practices and other conflicts of interest.

As to the first issue, I find no evidence indicating that investment banks were either supporters or intended beneficiaries of the Glass-Steagall Act. Regarding the second and third issues, I offer preliminary responses indicating that Congress had substantial reasons to believe that universal banks presented serious risks to the banking system and the broader economy.

### **Were Traditional Securities Firms Supporters or Intended Beneficiaries of the Glass-Steagall Act?**

Several scholars have advanced an “interest group” explanation for the Glass-Steagall Act. They contend that traditional investment banks encouraged Congress to adopt the 1933 legislation in order to remove their commercial banking rivals from the securities underwriting business.<sup>134</sup> It is certainly true that, from the mid-1960s through the end of the 1980s, securities firms and their trade associations fought hard to maintain the wall of separation created by the Glass-Steagall Act. It was not until the early 1990s that leading securities firms decided to support universal banking legislation, after failing to overturn federal agency rulings that opened major loopholes in the Glass-Steagall Act.<sup>135</sup>

Notwithstanding the securities firms’ modern defense of the Glass-Steagall barriers, the available evidence does *not* show that traditional investment banks were supporters or intended beneficiaries of the Act. Jonathan Macey, a proponent of the “interest group” explanation for Glass-Steagall, has acknowledged that “few hints of such favoritism can be gleaned from the legislative history or from the statutory language itself.”<sup>136</sup> Indeed, the “interest group” theory does not square with the known facts about the 1933 legislation.

The Investment Bankers Association of America (IBA), the leading trade association representing securities firms, actively opposed the legislation. During congressional hearings on the Glass bill in 1932, Allan Pope, president of the IBA, strongly condemned the provisions requiring commercial banks to leave the business of investment banking. Pope testified that he had met with “several hundred members” of the IBA in a dozen major cities, and “without a single exception” all those members opposed the Glass bill.<sup>137</sup> Pope argued that a mandatory separation between commercial and investment banking would be “highly deflationary” and would “practically stop the security and industrial business of the country.”<sup>138</sup> He further declared that the Glass bill was “so highly detrimental to the investment market to-day as to unquestionably affect in a ruinous manner the banks throughout the country as well as investment banks.”<sup>139</sup>

Pope's testimony portrayed the IBA's membership as being firmly united in opposition to the Glass bill. It could be argued that Pope's testimony is not conclusive on this point. As Donald Langevoort has noted, "control of the [IBA] ... had fallen to the commercial bankers" by 1930.<sup>140</sup> Pope himself was executive vice president of the securities affiliate of the First National Bank of Boston.<sup>141</sup> Accordingly, Pope might have been inclined to exaggerate the degree of consensus among the IBA's members in opposing the Glass bill. However, no investment bank testified in favor of the Glass bill, a fact that tends to support Pope's claim that the IBA's membership universally opposed the bill.

Edwin Perkins has drawn the opposite inference from the absence of any traditional investment bankers among the list of witnesses who testified at the 1931 and 1932 Senate hearings on the Glass bill. From this absence, Perkins inferred that "older investment banking houses who had been losing the competitive battle with the more aggressive commercial banks now thought they saw an opportunity to reestablish their former dominant position in the underwriting field" by supporting the Glass bill.<sup>142</sup> This inference is contradicted, however, by the fact that leading partners of J.P. Morgan, the foremost private investment bank, strongly opposed the Glass-Steagall Act in their private dealings.<sup>143</sup> For example, during the summer of 1932, Russell Leffingwell, a Morgan partner with close personal connections to Franklin Roosevelt and the Democratic Party, wrote a personal letter urging Roosevelt to reject the Glass bill. Leffingwell argued that "we cannot cure the present deflation and depression" with the "prohibition and regulation stuff" proposed by Glass. Roosevelt, however, rebuffed Leffingwell's entreaty. Roosevelt declared that bankers were responsible for "grave abuses" during the period 1927–29, and it was therefore imperative for honorable bankers to "support wholeheartedly methods to prevent recurrence thereof."<sup>144</sup> Roosevelt subsequently made a campaign speech in which he urged the complete separation of commercial and investment banking.<sup>145</sup>

J.P. Morgan's opposition to Glass-Steagall is further indicated by its decision in 1935 to abandon the securities business and remain a deposit-taking bank. Drexel & Co. (Morgan's affiliate in Philadelphia) and Brown Brothers Harriman (another leading private investment bank) made the same choice. Several partners from J.P. Morgan and Drexel resigned to form Morgan Stanley, a new investment bank-



ing firm. J.P. Morgan provided most of the initial financing for Morgan Stanley. During the early years of Morgan Stanley's operation, partners in the two firms maintained close relations, and they clearly hoped that Congress would amend or repeal Glass-Steagall so that they could once again operate as a single firm. Other traditional investment banks—including Kuhn, Loeb; Lazard Freres; and Lehman Brothers—opted to become securities firms. As indicated by these varying responses to the Glass-Steagall Act, it was doubtful whether traditional investment banks would actually benefit from the legislation, given (1) the heavily depressed condition of the securities markets during the early 1930s, and (2) Section 21 of the Act, which prohibited securities firms from accepting deposits.<sup>146</sup>

Another problem with the “interest group” explanation of Glass-Steagall is that the Senate's investigation of Wall Street practices during 1932 and 1933 did not spare traditional investment banks. As discussed below, the Pecora committee's investigation in 1933 was particularly harsh toward NCC and Chase and their securities affiliates. However, the Senate's investigation also revealed highly unfavorable information about traditional securities firms, including (1) Halsey, Stuart's role in aggressively marketing securities issued by the Insull utility empire prior to its bankruptcy in 1932; (2) Lee, Higginson's similar promotion of securities issued by Ivan Kreuger's companies before they collapsed in 1932; (3) Goldman Sachs' sponsorship of Goldman Sachs Trading Corporation, a highly leveraged investment trust whose shares became worthless by 1933; (4) J.P. Morgan's similarly ill-fated sponsorship of three large investment trusts, and its practice of allocating shares of newly underwritten securities to “preferred lists” of influential politicians and businessmen at heavily discounted prices; and (5) Kuhn, Loeb's and Dillon Read's promotion of several investment trusts that inflicted large losses on ordinary investors.<sup>147</sup>

As a consequence of the Senate's investigation, journalists harshly criticized J.P. Morgan and other private investment banks, and the public's reaction against investment banks was “almost as condemnatory” as the outcry against NCB, Chase and their affiliates. Public attacks on investment banks helped to persuade Congress to enact the Securities Act of 1933 despite the lobbying efforts of Wall Street bankers.<sup>148</sup> Hostility to investment banks also surfaced in Section 21 of the Glass-Steagall Act, which prohibited any person or firm

from accepting deposits if they engaged in the business of underwriting, selling, or distributing securities.<sup>149</sup>

During the Senate debates on the Glass-Steagall Act, Senator Tydings of Maryland offered an amendment to Section 21. The Tydings amendment would have exempted investment banks from the prohibition on deposit taking if they satisfied certain safeguards. Tydings declared that he was in favor of separating commercial banks from the securities business. However, he argued, “private investment houses of the better class” (such as his constituent, Alexander Brown & Sons of Baltimore) performed a vital public service in “financing private businesses ... on long-term paper.” He warned the Senate that Section 21 would impair the availability of credit by undermining “the usefulness of bona fide, finely run and conducted private institutions.”<sup>150</sup>

Senators Bulkley and Glass strongly opposed the Tydings amendment and persuaded the Senate to reject the amendment. Bulkley declared that an absolute prohibition on deposit taking by securities firms was “vital to the principles” of the Glass-Steagall Act. Glass agreed that this prohibition was a “vital provision of the bill,” because it would “confine to their proper business activities these large private concerns” and would “deny them the right to conduct the deposit bank business.” Glass reminded the Senate that private investment banks had “unloaded millions of dollars of worthless investment securities upon the banks of this country.” He also predicted that “there will be no difficulty ... in financing any business enterprise that needs to be financed at a profit in this country [because] large investment houses will be set up in this country, just as they have been in all of the countries of continental Europe, and in England.” In fact, Glass noted, officials of Chase’s securities affiliate were already taking steps to reorganize the affiliate as a separate investment bank.<sup>151</sup>

The public legislative history of Section 21, including the Senate’s defeat of the Tydings amendment, supports the view that the Glass-Steagall Act was designed to carry out a complete separation of the commercial and investment banking businesses. That history strongly undercuts the view that Glass and his supporters sought to protect securities firms from competition by commercial banks. Section 21 “severely hurt the private bankers” who chose to become se-

curities firms, because it deprived them of an important source of funding (i.e., deposits) and made them more dependent on loans from commercial banks.<sup>152</sup> The successful opposition of Glass and Bulkley to the Tydings amendment clearly indicated that investment banks were *not* intended beneficiaries of the Glass-Steagall Act.<sup>153</sup>

As Donald Langevoort has observed, the provisions and history of the Glass-Steagall Act demonstrate that the legislation had a “channeling objective”—to confine banks to “the traditional business of commercial and agricultural lending” and to prevent bank deposits from being used to fund loans for speculative purposes.<sup>154</sup> The available evidence—particularly with regard to Section 21—contradicts any inference that the Act was designed to favor securities firms.

Glass’s conduct two years later further undermines any such inference. Glass tried to include a provision in the Banking Act of 1935 that would have given commercial banks a limited authority to underwrite and sell debt securities (but not equity stocks). Under Glass’s proposal, commercial banks could have underwritten or sold debt securities to dealers or brokers (other than banks), or at public auction, under rules established by the Comptroller of the Currency. Glass argued that commercial banks should be granted a carefully limited power to sell debt securities because securities firms were not providing adequate long-term financing to industrial corporations.<sup>155</sup> Since Glass’s proposal would have allowed commercial banks to make a partial reentry into the securities underwriting business, it certainly did not reflect any desire to protect securities firms. Indeed, Glass explained that he was disappointed by the poor performance of securities firms in arranging long-term financing for industrial firms, contrary to his optimistic expectations in 1933.<sup>156</sup>

The Senate adopted Glass’s proposal over the vocal opposition of Senator Robert LaFollette. In opposing Glass, LaFollette did not express any solicitude for securities firms. Instead, he reiterated the same arguments advanced in 1933 in favor of “a complete divorcement and separation between investment and commercial banking in this country.” LaFollette declared that “the underwriting and sale of securities by commercial banks . . . served to wipe out the reserves and the savings of a lifetime which millions in this country had accumulated.” In LaFollette’s view, “the whole experience of the investing

public and of the people of the United States during the boom and the depression proves that [Glass's] proposal is loaded with dynamite as far as the investing public in the future is concerned."<sup>157</sup> Glass's proposal was opposed by the Roosevelt Administration and was omitted from the conference report on the 1935 legislation.<sup>158</sup> Thus, as in the case of the Glass-Steagall Act, the debates on Glass's proposal in 1935 did not indicate any congressional purpose to protect securities firms from competition.

### **Did Securities Activities Threaten the Safety of Banks During the 1930s?**

George Benston has concluded that "[t]he evidence from the pre-Glass-Steagall period is totally inconsistent with the belief that banks' securities activities or investments caused them to fail or otherwise caused the financial system to collapse."<sup>159</sup> Benston relied extensively on a study by Eugene White, who found that "[f]ew banks with [securities] affiliates failed; and even though Congressional hearings may have uncovered some problems, the securities affiliates did not systematically undermine the capital or liquidity provisions of national banks."<sup>160</sup> White determined that 26.3 percent of all national banks failed during the period 1930–33, compared with only 6.5 percent of banks with securities affiliates and only 7.6 percent of banks with large bond departments. White noted, however, that "the typical bank involved in investment banking was far larger than average, while most of the failures were among the smaller institutions."<sup>161</sup> Larger banks had a higher probability of survival during the Great Depression, because (1) their assets were more diversified in comparison to smaller banks, and (2) they were more likely to receive financial support from other banks and the Reconstruction Finance Corporation (RFC). Due to the higher survival rate for large banks, depositors shifted their funds from smaller banks to larger banks during the banking panics of 1930–33.<sup>162</sup> Consequently, White's data on bank survival do not permit us to separate the impact of securities activities from the positive effect of larger size.

White also performed regressions based on data for bank failures during 1931. He concluded that, during that year, the presence of a securities affiliate "tended to reduce the likelihood of failure" while the presence of a bond department "did not increase the probability of failure." Again, however, White's regression analysis is not conclu-

sive, because his sample did not enable him to measure the impact of differences in bank size. In addition, White did not consider the significance of specific incidents in which major banks with securities affiliates failed during 1930, 1932, and 1933.<sup>163</sup>

One problem in isolating the effect of securities activities on bank failures is that banks failed for various reasons during the Great Depression. It appears, however, that losses from defaulted real estate loans and depreciated securities investments were two of the most important causes of bank failures from 1930 to 1933. As described above, real estate lending and investments in higher-risk securities were two leading sources for the financing surge of the 1920s. Both activities required banks to invest in assets that were subject to potential liquidity problems, and both markets experienced speculative booms during the 1920s. It is therefore not surprising that both activities proved to be serious threats to bank solvency during the early 1930s.

Default rates rose rapidly for both residential and commercial mortgages and reached crisis proportions in 1931–32. Real estate values in many urban areas fell by a third or more in 1929–31, and a large number of urban real estate markets were essentially frozen by 1932. Banks often could not liquidate defaulted loans by foreclosing on the real estate collateral, because no buyers were available to pay any reasonable price for the property. The illiquid status of defaulted real estate loans was a significant factor explaining the loss of bank capital during the 1930s.<sup>164</sup>

Many banks were also devastated by depreciation in their securities portfolios. As noted above, both domestic and foreign bonds experienced sharp increases in default rates and rapid declines in market values from 1931 to 1933.<sup>165</sup> Losses on South American and Eastern European bonds were especially severe, as three-quarters of those bonds defaulted during the 1930s.<sup>166</sup> An analysis of closed New York state banks found that their securities portfolios had suffered an average loss in market value of 37.5 percent. A similar study of closed Michigan banks determined that depreciation in their bond portfolios (particularly with regard to real estate bonds) was a primary reason for their failure.<sup>167</sup> From 1929 to 1932, the losses suffered by national and state member banks on securities

investments were comparable in magnitude to their losses on loans.<sup>168</sup> A recent study by Calomiris and Mason confirms that defaulted real estate loans and depreciated securities were important causes of bank failures.<sup>169</sup>

Smaller banks suffered the greatest percentage losses from securities investments, because higher-risk securities represented a higher proportion of their investment portfolios. Among Federal Reserve member banks, country banks held larger amounts of foreign bonds and railroad bonds than reserve city banks did.<sup>170</sup> Some commentators blamed country bankers for their lack of prudence in pursuing higher yields without regard to risk.<sup>171</sup> However, members of Congress and other commentators strongly criticized securities affiliates of commercial banks and traditional investment banks for aggressive marketing campaigns that encouraged unsophisticated country bankers to buy risky securities.<sup>172</sup> Country banks relied heavily on their correspondent banks in major cities for a wide range of banking services, including investment advice and the sale of investment securities.<sup>173</sup> Allan Pope, executive vice president of First National Bank of Boston's securities affiliate, acknowledged in 1931 that country bankers sought his company's investment advice because they were "unfamiliar with the investment markets."<sup>174</sup> In 1932, he testified that 600 country banks relied on his affiliate for investment recommendations, "based on our broad expanse of knowledge." According to Pope, some country bankers had been specifically instructed by bank examiners to "take our advice in security matters."<sup>175</sup>

Thus, it appears that bank securities affiliates contributed to the failure of many small correspondent banks by persuading them to invest in high-risk bonds, particularly foreign issues. The linkage between bank securities activities and bank failures is a worthwhile subject for future research, but for present purposes, I will simply note the following evidence indicating that bank securities affiliates did create significant risks for large banks and the banking system from 1930 to 1933.

### *The Failures of Several Key Banks with Securities Affiliates*

Between 1930 and 1933, the failures or near-failures of several key banking organizations resulted, at least in part, from their involvement in securities activities. In 1930, Caldwell and Company and Bank of United States failed. Those failures precipitated the first banking crisis of the Great Depression. In 1932, the RFC was forced to provide large loans in order to (1) protect the depositors of Central Republic Bank and (2) ensure the survival of Bank of America. In 1933, the failure of four important banks with securities affiliates—two in Detroit and two in Cleveland—precipitated statewide banking holidays that helped to trigger a nationwide banking panic.

#### *Caldwell and Company and Bank of United States*

Caldwell and Company (CAC) established a large financial and industrial empire that covered much of the Southeast. CAC was a leading underwriter of municipal bonds, industrial revenue bonds, and real estate bonds throughout the Southern states. By the end of 1929, CAC controlled a large chain of banks with more than US\$210 million of assets, insurance companies with more than US\$230 million of assets, and newspapers and industrial companies with almost US\$50 million of assets. In early 1930, CAC merged with BancoKentucky Company, which controlled 10 banks with assets of almost US\$140 million.<sup>176</sup>

CAC obtained extensive loans from its bank affiliates, as well as other banks in the Southeast. CAC aggressively speculated in stocks on Wall Street. CAC also held large amounts of illiquid securities representing investments in its affiliates and unsold securities from its underwritten offerings.<sup>177</sup> CAC's entire financial structure was unsound and collapsed in November 1930. CAC's demise precipitated the failure of more than 130 banks in Arkansas, Kentucky, North Carolina, and Tennessee, thereby inflicting a severe economic shock on the Southeast's regional economy.<sup>178</sup>

Bank of United States (BUS) was a New York City bank that expanded rapidly during the late 1920s by acquiring five other banks. By May 1929, BUS had 57 branches, US\$315 million of assets, and US\$220 million of deposits. BUS controlled three securities affiliates, three safe deposit companies, an insurance company, and dozens of

real estate affiliates.<sup>179</sup> BUS and its real estate affiliates made large loans to real estate developers and invested in real estate bonds. BUS also made substantial loans to its officers and securities affiliates for the purpose of financing continuous trading in units consisting of BUS stock joined with the stock of its major securities affiliate. By 1930, BUS had committed US\$16 million (equal to one-third of its capital) to support the price of its stock units. BUS was strongly motivated to maintain the price of its stock units, because BUS had agreed to repurchase those units at a guaranteed price from many of its shareholders, including depositors to whom BUS had actively marketed the units.<sup>180</sup>

BUS was doomed when the real estate and stock markets slumped after the Crash of 1929. At the time of its failure in December 1930, BUS had outstanding more than US\$20 million of unpaid loans to its securities and real estate affiliates, as well as US\$11 million of unpaid loans to its officers and other persons that were collateralized by its stock units. BUS's affiliates incurred a loss of at least US\$16 million on their holdings of BUS stock units. Large amounts of BUS's real estate loans and bonds were either in default or likely to default.<sup>181</sup> BUS failed after the New York state banking department and the Federal Reserve Bank of New York could not persuade members of the New York Clearing House Association (NYCHA) to provide support for an emergency merger of BUS with two other New York City banks.<sup>182</sup> BUS's failure led to the collapse of Chelsea Bank, a smaller New York City Bank that was closely connected with BUS. Depositor runs began at two larger banks—Manufacturers Trust and Public National—that were also linked with BUS. Members of the NYCHA intervened to rescue those banks and avert a more widespread banking panic.<sup>183</sup>

Scholars have debated whether BUS's failure aggravated the economic decline that was already under way in the United States. Regardless of its direct economic impact, there can be little doubt that BUS's failure had a significantly adverse impact on public confidence in banks. BUS ranked among the 30 largest commercial banks in the nation, and it was the largest single bank failure in U.S. history up to that time. Both domestic and international newspapers gave extensive coverage to BUS's failure, because of its name and its membership in the Federal Reserve System. Together with the collapse of CAC, the



failure of BUS produced a substantial outflow of currency from the banking system as depositors converted their deposits into cash. That outflow indicated a significant loss of confidence in the U.S. banking system.<sup>184</sup>

### *The Chicago Banking Panics and Central Republic*

In June 1931, a serious banking panic occurred in Chicago. During Chicago's real estate boom of the mid-1920s, the city's banks expanded rapidly and devoted much of their resources to real estate lending. As the result of numerous mergers, two giant banks—Continental Illinois Bank and Trust Company (Continental Illinois) and First National Bank of Chicago (First Chicago) controlled two-thirds of Chicago's banking resources by 1931. Many of the larger Chicago banks and their securities affiliates sold real estate bonds to investors with an explicit or implicit undertaking to repurchase the bonds upon request. Chicago banks and their securities affiliates distributed other types of securities, including municipal bonds and bonds issued by Samuel Insull's utility empire. Banks and their affiliates were also exposed to the securities markets as a consequence of their investment securities and security loans.<sup>185</sup>

Given their heavy involvement in real estate activities, many Chicago banks became highly vulnerable after the city's real estate boom ended in 1928. By June 1931, a chain of banks controlled by the Foreman State Bank was faced with imminent depositor runs, because Foreman could no longer repurchase real estate bonds that its securities affiliate sold to depositors. To avoid the collapse of the entire Foreman chain, First Chicago agreed to acquire most of the Foreman banks with financial help from the Chicago Clearing House Association (CCHA). In addition, the National Bank of the Republic, which had been weakened by its own real estate problems, agreed to merge with Central Trust Company to form the Central Republic Bank and Trust Company (Central Republic). However, these measures did not prevent the demise of a chain of 12 banks controlled by John Bain, an aggressive real estate promoter. The Bain default was accompanied by the failures of another 20 banks. A full-scale panic was averted only when First Chicago and Continental Illinois publicly announced that they would support all of their local correspondent banks. The panic ended, but the resolution proved to be temporary.<sup>186</sup>

In the summer of 1932, another and more serious banking panic struck Chicago. The real estate situation in Chicago had grown worse, and more than US\$1 billion of mortgages were in default. Chicago's economy was also shaken by the collapse of the highly leveraged Insull utility system in the spring of 1932. Samuel Insull's holding companies, headquartered in Chicago, controlled a network of public utility companies serving more than 5,000 communities in 36 states. Insull and his investment bankers, led by the Chicago firm of Halsey, Stuart, had promoted the sale of Insull holding company securities to small investors. The securities affiliates of First Chicago, Continental Illinois, and Central Republic had participated in the distribution of Insull securities to the public, and they also invested in Insull securities. By the time the Insull holding companies were declared bankrupt in 1932, US\$2.65 billion of Insull securities had been sold to 600,000 shareholders and 500,000 bondholders. Chicago banks extended more than US\$150 million of loans to Insull companies and to other borrowers who offered Insull securities as collateral. Insull interests owed US\$90 million to the three leading banks, with Continental Illinois holding two-thirds of those loans. The Insull debacle thus wiped out the personal savings of thousands of Chicago area residents and threatened the solvency of many Chicago banks.<sup>187</sup> In addition, the Chicago city government was facing its own revenue crisis and could not pay its employees or bondholders.<sup>188</sup>

In this atmosphere of deepening economic crisis, Chicago residents lost faith in their banks. Thirty-six banks in Chicago failed between June 15 and 25, 1932. In sharp contrast to the 1931 panic, legions of frightened depositors descended on the three leading Chicago banks. Continental Illinois and First Chicago withstood the temporary panic among their depositors. In a dramatic gesture, Melvin Traylor, First Chicago's chairman, climbed on a pillar in the bank's lobby and persuaded a crowd of worried depositors to remain calm. Central Republic, however, could not withstand the pressure of escalating deposit withdrawals. On June 26th, Charles Dawes, chairman of Central Republic, informed Chicago's banking leaders and officials of the recently established RFC that he would have to close his bank unless a rescue plan was arranged to protect all of its depositors.<sup>189</sup>

In contrast to their successful self-help plan in 1931, Continental Illinois, First Chicago, and the CCHA could not finance the rescue of Central Republic. Chicago's banking leaders and RFC examiners determined that Central Republic needed an infusion of US\$95 million to remain open. The Chicago banks told the RFC that they could only offer US\$5 million in loans, thus revealing their gravely weakened condition. With the encouragement of President Hoover, the RFC determined that Central Republic must be rescued, because the bank's failure would lead to depositor runs on Chicago's remaining banks and a likely collapse of the entire U.S. banking system. In practical effect, the RFC treated Central Republic as being "too big to fail." Accordingly, the RFC agreed to provide a US\$90 million loan, secured by all of Central Republic's assets. The RFC's loan allowed Central Republic to continue in operation temporarily, but the bank could not survive. The 5½ percent interest rate charged by the RFC substantially exceeded the bank's return on its assets. In October 1932, Central Republic transferred all of its deposits to a newly organized bank, and Central Republic was liquidated thereafter.<sup>190</sup>

The RFC's protection of Central Republic's depositors temporarily calmed financial markets in Chicago and the nation. However, the incident revealed four very unpleasant facts about the nation's banking situation in mid-1932. First, bank failures, which had previously been confined to smaller and midsized banks (except for CAC and BUS), were spreading to large urban banks. Second, the most vulnerable urban banks were those that had engaged in extensive real estate and securities activities during the 1920s. Third, even the largest urban banks no longer had the resources to resolve serious banking panics without governmental assistance. Fourth, RFC loans provided only short-term relief and could not solve the fundamental problems confronting banks. The RFC required banks to pledge their best assets to secure 100 percent of the loans they received. RFC loans were made at penalty interest rates and could not exceed the estimated market or liquidation value of the banks' collateral. RFC loans also became a potential trigger for depositor runs after Congress required publication of the names of banks receiving RFC loans. For all these reasons, RFC loans failed to prevent a progressive collapse of the banking system during 1932 and 1933.<sup>191</sup>

*Threats to the Survival of Bank of America*

Bank of America, like other urban banks, expanded rapidly through mergers and acquisitions during the boom years of the 1920s. By 1930, Transamerica Corp., the parent holding company of Bank of America, was the third largest U.S. banking organization, trailing only Chase and NCB. Transamerica controlled more than 400 bank branches and US\$1.2 billion of banking assets in California, as well as a New York City bank with 35 branches and US\$400 million of assets. Transamerica also acquired a Wall Street securities firm, Bancamerica-Blair Corporation, which operated offices in 27 U.S. cities and 5 foreign countries.<sup>192</sup> Transamerica and Bancamerica-Blair financed substantial stock-trading operations designed to support Transamerica's stock price. Both companies also actively invested in other stocks, and Bancamerica-Blair was a major distributor of securities to retail customers.<sup>193</sup>

By 1931, Bank of America and Transamerica found themselves in great difficulty. Bank of America was rapidly losing deposits, and many of its residential and commercial real estate loans were in default or danger of default. Transamerica and Bancamerica-Blair suffered large losses on their stock investments and loans on securities. Elisha Walker, the recently elected chairman of Transamerica, decided to retrench. He engineered the sale of the New York City bank and Bancamerica-Blair to NCB in October 1931. Walker completed this transaction over the strenuous opposition of A.P. Giannini, the founder and former chairman of Bank of America and Transamerica.<sup>194</sup>

A fight for corporate control ensued. Giannini prevailed in a proxy contest and regained control of Transamerica in February 1932. The RFC immediately offered to provide up to US\$100 million of credit to support Giannini's rehabilitation plan for Bank of America. The RFC ultimately loaned US\$65 million to Bank of America and Transamerica, thereby helping Giannini to rebuild Bank of America.<sup>195</sup> As in the case of Central Republic, the RFC determined that Bank of America's survival was crucial to the stability of the U.S. banking system. The RFC made US\$1.1 billion of loans to help banks between February 1932 and March 1933. Of that amount, US\$155 million, or 14 percent, was devoted to the support of Central Republic and Bank of America.<sup>196</sup>

*Major Bank Failures in Detroit and Cleveland in 1933*

During the late 1920s, two major bank holding companies were created in Michigan through a series of mergers and acquisitions—the Detroit Bankers Company (Detroit Bankers) and the Guardian Detroit Union Group (Guardian). By 1931, both groups owned banks throughout the state of Michigan and controlled three-fifths of the banking resources in Detroit and the state as a whole. Detroit Bankers and Guardian flourished during the economic boom experienced by Detroit and Michigan during the 1920s, as a result of the automotive industry’s rapid expansion. Both organizations made large amounts of residential and commercial real estate loans. In addition, both companies established securities affiliates, which invested in the stocks of their parent holding companies and in other securities. Both groups also made security loans to finance investments by their officers, directors, and other persons in the groups’ holding company stocks and other stocks.<sup>197</sup>

Both Detroit Bankers and Guardian were in serious trouble by 1932. Domestic production of automobiles, which was heavily concentrated in the area around Detroit, fell by three-quarters between 1929 and 1932. Detroit’s economy was devastated by a drastic decline in economic activity and high unemployment caused by the automotive industry’s severe slump.<sup>198</sup> By the end of 1932, property values in Detroit had fallen by nearly half, and there were no buyers to whom the banks could sell their foreclosed real estate. The two Detroit banking groups experienced cascading defaults on their real estate mortgages. About a third of Guardian’s total assets were committed to real estate loans or investments in real estate, while real estate commitments represented about 40 percent of the banking assets of Detroit Bankers.<sup>199</sup>

Both banking groups also suffered heavy losses from their securities activities. The Guardian banks held large amounts of the holding company’s stock as collateral for loans, and the value of that stock plummeted from US\$350 to US\$5.50 per share by May 1932. In addition, the holding company, supported by its largest bank and major shareholders, obtained US\$7 million of loans from New York banks to enable its securities affiliates to carry depreciated securities in their inventories. A Guardian executive later acknowledged that one of Guardian’s securities affiliates inflicted “several millions” of losses

on the group.<sup>200</sup> Similarly, by 1932 the largest bank in the Detroit Bankers group held US\$25 million of loans collateralized by the holding company's stock, which had fallen in value from US\$300 to US\$9 per share. From 1931 to 1932, Detroit Bankers incurred losses of at least US\$29 million on securities investments.<sup>201</sup>

Guardian asked for the RFC's assistance in 1932, and the RFC provided an US\$8.7 million loan. In January 1933, Guardian asked for an additional US\$50 million to save itself from imminent collapse. However, the RFC determined that Guardian's available assets could only support a loan of US\$37 million. In a desperate effort to arrange a rescue package, the RFC and the Hoover Administration urged Henry Ford, Guardian's largest shareholder, to subordinate his deposits in Guardian's banks. Ford refused, and he also threatened to withdraw his deposits from banks owned by Detroit Bankers, a step that would have ensured their demise. To avoid the simultaneous failure of Guardian and Detroit Bankers, Michigan's governor declared a statewide bank holiday on February 14, 1933. Both banking groups were placed in receivership and were too weak to be reopened after the national bank holiday ended in March. With the help of the RFC, Ford and General Motors took the lead in organizing and capitalizing two new banks to serve the Detroit area.<sup>202</sup>

The Michigan bank holiday had a devastating effect on public confidence in banks across the country. For the first time, the RFC had failed in its efforts to rescue major urban banks that were considered essential to the stability of the banking system. Almost immediately, the two largest banking groups in Cleveland—the Union Trust Company (Union Trust) and the Guardian Trust Company (Guardian Trust)—suffered heavy deposit withdrawals.<sup>203</sup> Similar to the big Detroit banks, Union Trust and Guardian Trust had grown rapidly during the 1920s and were heavily engaged in real estate lending and real estate investments. In addition, by 1933 the two groups held a total of US\$25 million of unpaid loans extended to the insolvent empires of Cyrus Eaton and the Van Sweringen brothers.<sup>204</sup>

Union Trust and Guardian Trust also resembled the Detroit banks in their extensive involvement in securities investment and trading activities. By 1932, Union Trust and Guardian Trust had incurred losses of US\$16.4 million and US\$6.6 million, respectively, from depreciation in their securities portfolios. Both groups included secu-

rities affiliates. Guardian Trust's securities affiliate was relatively small, but Union Trust's affiliate was a major regional distributor of securities. By 1933, the net worth of both affiliates was essentially zero, and together they owed about US\$5 million to their parent holding companies.<sup>205</sup>

The RFC extended about US\$30 million of loans to Union Trust and Guardian Trust in 1932, but the Cleveland banks were too deeply insolvent to be saved in 1933.<sup>206</sup> On February 27, the Ohio legislature authorized all Ohio banks to impose stringent limits on deposit withdrawals. Those restrictions were immediately applied by the Cleveland banks. By March 4, every other state had followed Michigan and Ohio in declaring some type of bank holiday or other restriction on deposit withdrawals. Following the national bank holiday, Union Trust and Guardian Trust were liquidated. Many of their deposits were transferred to other Cleveland banks, which reopened with RFC assistance.<sup>207</sup>

### **Large Losses at Other Major Banks with Securities Affiliates**

As shown above, the failures of several large banking organizations with extensive securities activities played key roles in the progressive collapse of the U.S. banking system from 1930 to 1933. In addition, three of the four banks with the largest securities affiliates in 1930—NCB, Chase, and Continental Illinois<sup>208</sup>—incurred heavy losses and experienced wrenching changes during the next few years. NCB's affiliate, NCC, suffered losses of US\$100 million during the period 1930 to 1933, including heavy losses on its equity investments. NCB was burdened with US\$80 million of frozen "bridge loans" extended to NCC clients in expectation of bond offerings that were never completed, as well as several million dollars of loans extended to NCB's officers to finance their purchases of NCB's stock. NCB recorded total losses of US\$170 million from 1930 to 1934, wiping out two-thirds of its shareholders' equity at the end of 1929.<sup>209</sup>

Chase's affiliate, CSC, wrote down its capital by US\$55 million during the period 1930 to 1933, reflecting heavy losses on its equity investments. Chase reported total losses of US\$130 million from 1930 to 1934, reducing its net worth at the end of 1929 by more than half. Many of Chase's losses resulted from (1) loans made to the Republic of Cuba to support CSC's underwriting of Cuban bonds, and

(2) loans and equity investments in support of General Theatres Equipment, a bankrupt company that had been a major client of CSC.<sup>210</sup>

Continental Illinois suffered the worst losses in proportion to its capital, due in large part to its heavy involvement with Samuel Insull's utility system. Continental Illinois recorded US\$110 million of losses from 1932 to 1933. It was the first major bank to sell preferred stock to the RFC in connection with the recapitalization authority granted to the RFC under the Emergency Banking Act of 1933. Continental Illinois sold US\$50 million of preferred stock to the RFC and reduced its own common stock to US\$25 million, thereby recognizing that the RFC would hold the controlling interest in the bank. The RFC promptly designated a new chairman for Continental Illinois.<sup>211</sup> NCB and Chase also each sold US\$50 million of preferred stock to the RFC in late 1933, a step that helped each of them to write off losses on depreciated investments and nonperforming loans.<sup>212</sup>

The RFC bought more than US\$360 million of preferred stock from 40 of the 100 largest U.S. banks.<sup>213</sup> By the time the preferred stock program ended in 1935, the RFC had provided US\$1.3 billion of new capital to 6,800 banks. At that point, the RFC held one-third of all bank capital, and it was a stockholder in half of the nation's banks.<sup>214</sup> The magnitude of these figures indicates the weakness of the U.S. banking industry in 1933 and the strong need for government-sponsored recapitalization. The RFC staff determined that only 20 of the banks that sold preferred stock to the RFC had no real need for additional capital.<sup>215</sup> Together with the newly created program of federal deposit insurance, the RFC's preferred stock program played a key role in helping the banking system to recover after the national bank holiday.<sup>216</sup>

Notwithstanding RFC help, the banks that had profited most from the boom years of the 1920s still bore painful scars from the Great Depression. In mid-1933, the stock prices for NCB, Chase, and Continental Illinois were all more than 90 percent below their peak 1929 values.<sup>217</sup> In sharp contrast to the 1920s, large banks no longer found it easy to raise new capital in the depressed securities markets of the early 1930s.<sup>218</sup> Responding to this "capital crunch," even the largest banks "scrambled to shed asset risk" by shifting from loans to highly



liquid assets like government securities and cash reserves.<sup>219</sup> The amount of outstanding bank loans fell almost in half from 1931 to 1935, while the percentage of bank funds invested in government securities nearly tripled during the period 1929 to 1934.<sup>220</sup> Thus, the drought in new bank lending and the halting recovery of the nation's economy after 1933 can be attributed, at least in part, to the banks' desire to increase their liquidity and reduce their credit risk exposure, given the terrible losses they had suffered from 1930 to 1933.<sup>221</sup>

### **Was Congress Correct in Believing That Securities Affiliates of Banks Were Linked to Conflicts of Interest and Other Abusive Practices?**

Several modern scholars have contended that Congress in 1933 did not have solid evidence for its belief that securities affiliates of commercial banks had committed serious abuses. Those scholars have pursued two major lines of attack on the Glass-Steagall Act. First, in a series of studies, scholars have concluded that “on average, the [securities affiliates of] banks did not sell any worse securities than comparable investment banks.”<sup>222</sup> Second, George Benston has contended that the Pecora committee's investigation “reveals surprisingly little support for the charges of abuse” by NCB, Chase, and their securities affiliates. Benston concludes that “the record does not support the belief that the pre-Glass-Steagall period was one of abuses and conflicts of interest on the part of banks involved with securities transactions, either directly or through affiliates.”<sup>223</sup>

I intend to provide a more complete response to these findings in a future article, after I have completed a full review of the Pecora hearings. For purposes of the present discussion, I offer two preliminary comments. First, Congress's decision to adopt the Glass-Steagall Act was not premised on the view that the underwriting record of commercial banks was worse than the underwriting performance of investment banks. Instead, Congress concluded that the involvement of commercial banks in securities underwriting was dangerous because (1) it compromised the banks' ability to act as impartial allocators of credit and as objective providers of investment advice, and (2) it created a hypercompetitive underwriting market that encouraged both commercial and investment banks to promote speculative, high-risk issues. Second, a number of scholars have concluded, in

contrast to Benston, that the Pecora committee did uncover substantial evidence of abusive conduct by NCB and Chase, the two largest commercial banks with the two most important securities affiliates.

### **The Comparative Underwriting Performance of Commercial Bank Affiliates and Traditional Investment Banks**

A number of scholars have examined the comparative underwriting record of commercial bank affiliates and traditional investment banks during the 1920s. Two early studies concluded that the performance of securities underwritten by commercial bank affiliates, in terms of default history and stability of market price, was about the same as the record for securities underwritten by traditional investment banks.<sup>224</sup> Using regression analysis, three modern studies found that securities underwritten by commercial bank affiliates generally performed better than securities underwritten by investment banks.<sup>225</sup> However, two of those studies determined that commercial bank affiliates underwrote higher-quality securities. In this regard, the bonds underwritten by bank affiliates (1) were typically issued in bigger amounts by larger and more seasoned issuers and (2) carried lower yields (i.e., higher prices to investors). Thus, the superior performance of bonds underwritten by commercial bank affiliates was consistent with the fact that those bonds exhibited lower risk and “were priced higher” at the time of their issuance.<sup>226</sup> Bank affiliates were involved in syndicated offerings that typically included a larger number of underwriters, thereby indicating that bank affiliates were chosen for their “large distribution networks that [could] provide a comparative advantage in handling large, syndicated issues.”<sup>227</sup>

The foregoing studies indicate that the underwriting performance of commercial bank affiliates was generally comparable to the record for traditional investment banks, after taking account of the higher quality of bonds underwritten by the bank affiliates. However, two of the studies also identified outliers in the bank affiliate and investment bank groups. One study found that bonds underwritten by J.P. Morgan and Kuhn, Loeb, the leading private investment banks, compiled the best default performance among all underwriters for bonds issued during the period 1926 to 1930.<sup>228</sup> In contrast, bonds underwritten by NCB and Chase, the two largest banks with the two most important securities affiliates, posted a default record that was inferior to the performance of bonds underwritten by other bank

affiliates and, in one study, was also worse than the performance of bonds underwritten by investment banks.<sup>229</sup> In addition, the stock prices of NYSE-listed companies that issued bonds underwritten by NCB and Chase performed “somewhat more poorly” than NYSE-listed companies that issued bonds underwritten by other underwriters.<sup>230</sup> Thus, the two commercial bank affiliates that were most prominent in the securities business, and that received the greatest scrutiny during the Pecora hearings, produced the worst overall record among bank affiliates.

Although the foregoing studies provide important data regarding the comparative underwriting performance of bank affiliates and investment banks, they do not respond to the core concerns of Congress in 1933. Congress did not enact the Glass-Steagall Act because it thought that commercial bank affiliates were more unscrupulous or less competent than traditional investment banks. Instead, Congress concluded that the involvement of commercial banks in securities underwriting was dangerous because (1) it promoted excessive competition within the underwriting business and encouraged *both* commercial banks and investment banks to abandon prudential standards and promote speculative, unsound issues, and (2) it undermined the ability of commercial banks to act as impartial allocators of credit and objective providers of investment advice. In addition, Congress determined that it was hazardous to link the lending capacity of deposit-taking banks with the placing power of securities underwriters. In Congress’s view, the linkage of the two activities had produced a financing surge that led to speculative overinvestment during the period 1924 to 1929 and economic catastrophe during the period 1930 to 1933. Accordingly, the Glass-Steagall Act was motivated by Congress’s desire to prevent excessive speculation in the financial markets that could spill over into the general economy. Congress believed that the removal of deposit-taking banks from the securities underwriting business was a prophylactic measure needed to accomplish its anti-speculative purpose.<sup>231</sup>

During its deliberations on the Glass-Steagall Act, Congress did not focus on the comparative underwriting performance of commercial bank affiliates and investment banks because that comparison was not pertinent to its central objective. As indicated above, Congress clearly believed that investment banks engaged in abusive prac-

tices and promoted the sale of highly speculative securities (especially those issued by foreign governments, investment trusts, and utility holding companies) during the 1920s.<sup>232</sup> Congress's investigation of investment banks provided the impetus for several statutes designed to regulate the conduct of firms that issue and underwrite securities, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940.<sup>233</sup> Congress determined that its anti-speculative purpose could be accomplished by restricting the lending power of investment banks. Congress adopted Section 21 of the Glass-Steagall Act to prohibit investment banks from accepting deposits, thereby severing underwriters of securities from a major funding source.<sup>234</sup> In contrast, Congress did not see any reliable means, short of strict separation, for keeping commercial banks from using their deposit-based lending capacity to promote speculative and destructive behavior in the securities markets.<sup>235</sup>

### **The Pecora Committee's Evidentiary Record**

The hearing transcripts and summary report produced by the Pecora committee during its investigation of 1933–34 are the primary sources of evidence relating to allegations of conflicts of interest and other abusive practices involving securities affiliates of commercial banks.<sup>236</sup> After reviewing those materials, George Benston concluded that the Pecora committee's investigation produced "very little evidence" of the alleged abuses.<sup>237</sup> Relying in part on Benston's work, Raghuram Rajan and Luigi Zingales similarly contend that "there is little evidence of the purported abuses in the specific cases examined by the Pecora Committee."<sup>238</sup> The conclusions of Benston, Rajan, and Zingales differ from the views of earlier scholars who reviewed the records of the Pecora investigation. I will not attempt to resolve this scholarly disagreement in this chapter. However, I intend to present my own evaluation of the Pecora hearings in a future article. For present purposes, I will provide a brief overview of the findings of scholars who have disagreed with Benston, Rajan, and Zingales.

Prior to Benston, W. Nelson Peach provided the most extensive analysis of the Pecora hearings. As Peach noted, the hearings focused particularly on NCB, Chase, and their securities affiliates (NCC and CSC). Peach determined that the Pecora investigation produced evidence of "[a] great many abuses and defects ... in connection with the

operation of security affiliates by national banks.”<sup>239</sup> Peach grouped those alleged abuses into four general categories: (1) the sale of “unsound and speculative securities,” accompanied by prospectuses that contained “untruthful and misleading information”; (2) “pool operations” that manipulated the stock prices of industrial corporations and the affiliates’ parent banks; (3) “the use of affiliates for the personal profit of officers of banks and affiliates”; and (4) “the mixing of commercial and investment banking functions.”<sup>240</sup> Subsequent scholars have agreed with Peach that the Pecora investigation provided substantial support for all of these allegations.

Regarding the first alleged abuse, Peach focused on the sale of foreign bonds, many of which had defaulted by the time of the Pecora investigation. Peach and subsequent scholars determined that commercial bank affiliates and traditional investment banks had been “indiscriminate” in underwriting speculative issues of foreign bonds, due to the lucrative fees that could be earned from that business. Peach and others charged that bank affiliates and investment banks sold foreign bonds to unsophisticated investors without disclosure of their inherent risks.<sup>241</sup> In concluding that bank affiliates sold foreign bonds while disregarding known risks, Peach and other scholars cited NCC’s decision to underwrite bonds issued by the Republic of Peru and the Brazilian state of Minas Gerais despite reports from NCC’s agents indicating that neither government would be able to repay its debts.<sup>242</sup>

Concerning the second alleged abuse, Peach and other scholars cited stock pool operations, in which NCC and CSC participated, that manipulated the stock prices of several major U.S. corporations. In addition, NCC and CSC helped to distribute shares of the same companies to public investors while their pool operations were artificially supporting the market price. Similarly, NCC and CSC maintained almost continuous pools to boost the stock prices for their parent banks while they actively promoted the distribution of those stocks to public investors.<sup>243</sup>

I will not recount Peach’s analysis of alleged abuses by officers of NCC and CSC, since those abuses were arguably the acts of rogue agents rather than conflicts of interest inherent in the bank-affiliate system.<sup>244</sup> In addressing the fourth alleged abuse, Peach concentrated

on financial arrangements between banks and their securities affiliates. In one case, NCB transferred to NCC US\$25 million in defaulted Cuban sugar loans, which bank examiners had criticized. NCB accomplished this transfer by selling US\$50 million of its stock and using the proceeds to increase the capital stock of NCB and NCC by US\$25 million each. NCC transferred the US\$25 million it received to a subsidiary, which paid the same US\$25 million to NCB to buy the defaulted loans. NCC later wrote down the value of its subsidiary to US\$1. In practical effect, NCB had used NCC as a dumping ground for its bad loans and as camouflage to prevent its shareholders from realizing that proceeds of NCB's stock sale were being used to write off the loans.<sup>245</sup>

In a second case, Chase provided more than US\$10 million of loans to support a public offering of US\$40 million of Cuban bonds by CSC and other underwriters at a time when Cuba was highly unlikely to repay either the loans or the bonds.<sup>246</sup> As noted above, Chase also lost US\$70 million on equity investments and loans it made to support CSC's underwriting activities for General Theatres Equipment, which declared bankruptcy in 1932.<sup>247</sup> NCB suffered losses on US\$80 million of bridge loans it extended to clients of NCC in connection with bond offerings that could not be completed.<sup>248</sup> In addition, unsound loans and investments made by banks to support the activities of securities affiliates were prominent features in the failures of CAC, BUS, and Central Republic.<sup>249</sup> As Peach explained, the symbiotic relationship between banks and their securities affiliates grew out of their deliberate decision to market themselves as unified, full-service organizations. Peach concluded that Congress could not have enacted legislation to prevent banks from supporting their affiliates without destroying the business plan on which they had operated during the 1920s:

Affiliates and banks were legally separate corporations. In practice, however, they were parts of the same organization ... providing their customers with complete financial facilities under one roof. The close relationship between banks and affiliates was intentionally fostered, and it was due to their ability to convince the investing public that bank and affiliate were part of the same organization that affiliates were able to sell such a large volume of securities during the twenties. Since, when the securities were sold, the public had

been persuaded that bank and affiliate were parts of the same organization, the bank could not escape responsibility for the activities of its affiliate when the securities began to decline in value after the stock market crisis of 1929. It became necessary for banks to assist their affiliates because they were aware that any diminution in the good will of their affiliates would bring with it a corresponding diminution in their own. This is the chief difficulty in the affiliate system. ... Any legislation which sought to prevent such relationships and the advantages arising from them would automatically destroy the basis on which the affiliate system was established.<sup>250</sup>

The most prominent example of Peach's thesis was NCB. By 1929, NCB was a "global, all-purpose financial intermediary [that] provided corporations, households, and governments with commercial banking, investment banking, and trust services."<sup>251</sup> NCB and its affiliates operated as a single enterprise that worked together to "tailor financial packages to the customer's requirements."<sup>252</sup> Accordingly, the concept of an integrated, full-service financial intermediary was "the rationale underpinning National City's comprehensive strategy."<sup>253</sup> Charles Mitchell publicly embraced this strategy when he declared that NCB's goal was to give its clients "a complete banking and investment and trust service. ... Now, if those businesses can be done by a single organization it is very much the better. ... Those are all functions which the average client likes to conduct under one roof, so to speak."<sup>254</sup> As the conduct of NCB, Chase, and other banks demonstrated, the 1920s concept of full-service department store banking strongly encouraged commercial banks to support their securities affiliates whenever the affiliates encountered serious problems.<sup>255</sup>

The abuses catalogued by Peach, particularly those dealing with the use of bank resources to support securities affiliates, appear to be substantial and warrant further analysis of the evidence produced by the Pecora investigation. Peach's doubts about the wisdom of allowing banks to combine lending, securities investments, securities underwriting, and investment advice are similar to current concerns about the highly integrated nature of today's financial conglomerates. For the same reasons voiced by Charles Mitchell, financial conglomerates currently seek to create synergies by marketing their services under a unified brand and by presenting themselves to customers as a

single enterprise offering “one-stop shopping.” Moreover, these institutions routinely offer package deals that combine lending and securities underwriting services for corporate clients. The close relationships among affiliated subsidiaries within a financial conglomerate make it unlikely that structural firewalls will be able to prevent serious problems in one subsidiary from endangering the entire organization.<sup>256</sup> Accordingly, a careful review of the Pecora committee’s investigation of NCB, Chase, and other universal banks of the 1920s may shed useful light on the potential risks of today’s financial conglomerates.

### **Conclusions and Directions for Further Research**

Carter Glass, Henry Steagall, and their supporters offered a critique of universal banking that was more persuasive than their modern critics have acknowledged. In Congress’s view, universal banks helped to foster a speculative boom from 1924 to 1929 that produced high-risk investments, hazardous debt burdens, and overextended real estate and industrial sectors, all of which contributed to the economic bust of 1930–33. Congress also determined that problems created by universal banks were important factors in the progressive collapse of the banking system during the period 1930–33. Congress placed much of the blame for the Great Depression on policy mistakes made by the Federal Reserve System from 1924 to 1933. However, Congress believed that universal banks helped to lay the foundation for the economic calamity that occurred during the early 1930s.

Based on the analysis set forth above, I have reached the following tentative conclusions regarding the claims made by Glass and his supporters in 1931–33. First, universal banks contributed to the extraordinary economic boom of 1924–29 by significantly expanding their involvement in five separate financing channels—loans on securities, securities investments, public offerings of securities, real estate mortgages, and consumer credit. Second, the large-scale entry of commercial banks into the securities markets created competitive pressures that caused commercial bank affiliates and traditional investment banks to abandon prudential standards and promote highly speculative domestic and foreign ventures. Third, the financing surge of the 1920s produced unsustainable asset booms in both the real estate and securities markets. It also left the consumer and business sec-



tors in a highly fragile condition at the end of 1929, due to their heavy debt burdens and risky investments.

Fourth, universal banks also contributed significantly to banking problems during the period 1930–33. The largest universal banks, which were also money center banks, undermined the soundness of smaller correspondent banks by encouraging them to purchase high-risk securities during the 1920s. Losses on securities proved to be a major cause of bank failures during the 1930s. In addition, several large universal banks failed in 1930, 1932, and 1933. Those failures triggered regional banking panics and also caused a widespread loss of depositor confidence in the banking system. Other universal banks avoided failure only because they received timely assistance from the RFC. Failures or near-failures of universal banks typically resulted from decisions by bankers to make risky investments and loans to support their own stock prices and to prop up affiliates and customers of those affiliates.

The experience of the U.S. banking industry from 1921 to 1933 raises provocative questions about the possible linkages between financial liberalization, broader powers for banks, asset booms, banking crises, and economic depressions. The evidence reviewed above suggests a clear connection between the liberalization of bank powers after 1910 and the tremendous expansion of financing for consumers and business firms after 1920. The financing surge of the 1920s coincided with extraordinary asset booms in the real estate and securities markets, and with rapid growth in business facilities and inventories. When the easy availability of credit and equity financing ended in 1929, the asset booms collapsed, followed quickly by sharp declines in consumer demand and industrial production. Within a year after the collapse of the asset booms, serious banking problems began to emerge. Were all of these events causally related?

In searching for answers to this question, scholars have reviewed the experiences of other nations during the 1920s and 1930s. Scholars have found that nations with prominent universal banks (e.g., Austria, Belgium, France, Italy, and Germany) experienced severe banking crises because their banks were weakened by close linkages with troubled industries. In contrast, nations with specialized banks that were barred from engaging in securities dealing or underwriting (e.g., Canada and the United Kingdom) survived the 1930s without a major

banking crisis. In addition, the presence of effective lenders of last resort in Canada and the United Kingdom helped to stabilize their banking systems.<sup>257</sup>

A particularly interesting contrast can be drawn between the experiences of the United Kingdom and the United States during this period. The narrow powers, oligopolistic structure, and conservatism of major U.K. banks during the 1920s contrasted sharply with the broad powers, competitiveness, and aggressive policies of leading U.S. banks. The United Kingdom experienced no boom during the 1920s but also avoided any banking crisis or severe economic slump during the 1930s. Does the U.K. experience suggest that countries that forgo financial liberalization can avoid the threat of a boom-and-bust cycle but must assume the risks of economic stagnation? Many British leaders were unhappy with the performance of the U.K. banking industry during the 1920s. Indeed, the 1931 report of the Macmillan Committee on Finance and Industry called upon Parliament to allow U.K. banks to enter the securities markets, as U.S. banks had done during the 1920s.<sup>258</sup> Of course, the Macmillan report was issued *before* the magnitude of the U.S. banking crisis became evident.

The experience of Japan since 1985 presents another instructive case study, which includes a number of features similar to the U.S. experience of 1921–33. Japan's government gradually deregulated its financial markets and followed a liberal monetary policy during the second half of the 1980s. During that period, Japan's economy benefited from a rapid growth in financing through increased bank lending and the issuance of new securities. The government allowed Japanese corporations to secure cheaper credit through increased access to the Japanese bond market and the Eurobond market. Because large Japanese corporations cut their demand for bank loans, Japanese banks eagerly expanded their involvement in real estate lending. Japanese banks were not allowed to engage in securities underwriting, but they were permitted to own corporate stocks. During the 1980s, Japanese banks built up huge portfolios of corporate shares to profit from the booming stock market and also to maintain strong cross-shareholding relationships with nonbank firms in the banks' respective corporate groups (*keiretsu*). Japanese regulators and the Basel Capital Accord of 1988 encouraged these stock investments by allowing Japanese banks

to rely on unrealized capital gains from their stock portfolios to satisfy a significant portion of their capital requirements.

The rapid expansion of securities issuances, securities investments, and bank loans produced a “bubble economy” in Japan during the late 1980s, as reflected in dramatic booms in the real estate and securities markets. Given the abundant sources of new financing, Japanese firms greatly increased their investments in production facilities, equipment, and real estate projects. In an effort to restrain the “bubble economy,” the Bank of Japan tightened its monetary policy significantly in 1990. The Bank of Japan’s restrictive monetary regime triggered a progressive collapse of both the securities and real estate markets. Japanese banks cut back on their lending, because they were burdened with severely depreciated stock portfolios and an estimated US\$1 trillion in nonperforming loans. The reluctance of Japanese banks to make new loans produced a severe “credit crunch” that lasted from the mid-1990s through 2004. Industrial production and consumer spending declined sharply during the 1990s, resulting in a prolonged economic slump. Despite more than US\$1 trillion of government stimulus programs and another US\$200 billion of government assistance for banks, the Japanese economy stagnated and several leading banks, securities firms, and insurance companies failed. Other major financial institutions survived only through government-supported mergers. Only in 2005 did analysts glimpse the beginning of a sustained recovery in the Japanese economy and banking system. As in the case of the worldwide Great Depression of the 1930s, analysts have studied the Japanese crisis to find clues to the apparent connections between financial liberalization, asset booms, and increased risks for systemic banking and economic crises.<sup>259</sup>

Finally, one might ask whether dangerous asset booms are more likely to occur during periods when major financial institutions face intense competitive pressures and also have a greater ability to exploit conflicts of interest. The concerns expressed by Congress in 1933 about universal banking powers—particularly with regard to conflicts of interest and links between lending and securities underwriting—have already been echoed by some commentators on the collapse of Enron and WorldCom and other financial scandals during the U.S. boom-and-bust cycle of 1994–2002.<sup>260</sup> I intend to examine those

scandals in a forthcoming article and to evaluate whether reforms are needed in the supervision of financial conglomerates.

## Notes

<sup>1</sup> The terms “bank” and “banking organization,” as used herein, include chartered banks, bank holding companies, and subsidiaries or affiliates thereof, unless the context indicates otherwise.

<sup>2</sup> Michael D. Bordo and David C. Wheelock, “Monetary Policy and Asset Prices: A Look Back at Past U.S. Stock Market Booms,” 86(6) *Review* (Federal Reserve Bank of St. Louis), at 24–25 (quote), 34–40 (November/December 2004); Robert Shiller, *Irrational Exuberance* 4–9 (Princeton, N.J.: Princeton University Press, 2000).

<sup>3</sup> Barrie A. Wigmore, *The Crash and Its Aftermath: A History of the Securities Markets in the United States, 1929–1933*, at 640–43 (tbl. A.20) (Westport, Conn.: Greenwood Press, 1985).

<sup>4</sup> E.S. Browing, “Year-End Review of Markets & Finance 2002: Investors Seek Ray of Hope,” *Wall Street Journal* (January 2, 2003), at R1.

<sup>5</sup> See Arthur E. Wilmarth, Jr., “The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks,” 2002(2) *University of Illinois Law Review* 215 [hereinafter Wilmarth, “Transformation”], at 223 n.23 (describing a “universal bank” as an organization that can engage, directly or through affiliates, in all aspects of the banking, securities, and life insurance businesses).

<sup>6</sup> Act of June 16, 1933, c. 89, 48 Stat. 162.

<sup>7</sup> See *infra* note 61 and accompanying text (discussing the strategy of “department store banking” employed by large banks that operated securities affiliates during the 1920s).

<sup>8</sup> Sections 20 and 32 of the Glass-Steagall Act prohibited banks from either (1) affiliating with securities firms, or (2) sharing directors, officers, or employees with securities firms. Act of June 16, 1933, c. 89, §§ 20 and 32, 48 Stat. 188, 194. Sections 5(c) and 16 of the Act barred member banks of the Federal Reserve System from underwriting or dealing in securities (except for “bank-eligible” securities such as U.S. government securities), and Section 21 forbade securities firms from accepting deposits. *Id.* §§ 5(c), 16 and 21, 48 Stat. 165, 184, 189. For discussions of these provisions, see, for example, Melanie L. Fein, *Securities Activities of Banks* §§ 1.02 and 4.03 (New York: Aspen Publishers, 3rd ed. 2005); Patricia A. McCoy, *Banking Law Manual* § 7.01 and 7.02[1] (Newark, N.J.: LexisNexis Group, 2nd ed. 2004).

<sup>9</sup> Fein, *supra* note 8, §§ 1.03–1.06 and 4.03; McCoy, *supra* note 8, §§ 7.01–7.03 and 7.04[1]; Wilmarth, “Transformation,” *supra* note 5, at 219–22, 306–07, 318–21.

<sup>10</sup> Act of November 12, 1999, Pub. L. No. 106-102, 113 Stat. 1338.

<sup>11</sup> *Id.* §§ 101 and 103, 113 Stat. 1341, 1342. GLBA also permits banks to establish financial subsidiaries. Financial subsidiaries may conduct securities underwriting and dealing and insurance agency activities, but they may not engage in insurance underwriting. *Id.* § 121, 113 Stat. 1373. GLBA did not repeal Sections 5(c), 16, and 21 of the Glass-Steagall Act. Accordingly, while banks and securities firms may affiliate with each other, banks may not engage directly in securities underwriting and dealing activities, and securities firms may not engage directly in a deposit-taking business. For general overviews of GLBA and the surviving provisions of the Glass-Steagall Act, see, for example, Fein, *supra* note 8, §§ 1.07, 2.01, 2.02[E][6], 3.01 and 4.03; McCoy, *supra* note 8, ch. 7.

<sup>12</sup> H.R. Rep. No. 106–74 (pt.1), at 97–98 (1999); S. Rep. No. 106–44, at 3–6; *see also id.* at 5 (quoting Federal Reserve Board Chairman Allan Greenspan’s statement that “archaic statutory barriers to efficiency could undermine the competitiveness of our financial institutions, their ability to innovate and to provide the best and broadest possible services to U.S. consumers, and, ultimately, the global dominance of American finance”).

<sup>13</sup> 145 Cong. Rec. S13913 (daily ed., November 4, 1999) (remarks of Sen. Gramm). Not all of GLBA’s proponents agreed with Senator Gramm. Some GLBA supporters indicated that the Glass-Steagall Act’s separation of commercial and investment banking served a beneficial purpose in the 1930s, but was no longer viable in light of changed conditions in the financial services marketplace. *See id.* at S13886 (remarks of Sen. Dodd); *id.* at 13890 (remarks of Sen. Bryan); *id.* at 13895 (remarks of Sen. Leahy).

<sup>14</sup> James A. Fanto, “Subtle Hazards Revisited: The Corruption of a Financial Holding Company by a Corporate Client’s Inner Circle,” 70 *Brooklyn Law Review* 7, at 13 (2004).

<sup>15</sup> For discussions of the involvement of universal banks in the Enron and WorldCom scandals, see, for example, Fanto, *supra* note 14, at 18–28; Fein, *supra* note 8, §§ 3.05[G][22], [23], and [27]; Hillary A. Sale, “Banks, the Forgotten (?) Partners in Fraud,” University of Iowa Legal Studies Research Paper No. 05-09, January 2005, <http://ssrn.com/abstract=673509>; Arthur E. Wilmarth, Jr., “Does Financial Liberalization Increase the Likelihood of a Systemic Banking Crisis? Evidence from the Past Three Decades and the Great Depression,” in Benton E. Gup, ed., *Too Big to Fail: Policies and Practices in Government Bailouts* 77 (Westport, Conn.: Praeger Publishers,

2004) [hereinafter Wilmarth, “Financial Liberalization”], at 85; *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 637–56, 695–704, 708 (S.D. Texas 2002); *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 636, 645–55, 678–98 (S.D.N.Y. 2004); Third Report of Neal Batson, Court-Appointed Examiner, *In re Enron Corp.*, Case No. 01–16034 (AJG) (Bkrcty. S.D.N.Y., filed June 30, 2003), at 34–81; Final Report of Neal Batson, Court-Appointed Examiner, *In re Enron Corp.*, Case No. 01–16034 (AJG) (Bkrcty. S.D.N.Y., filed November 4, 2003), at 63–81, 101–04; Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re WorldCom, Inc.*, Case No. 02–13533 (AGC) (Bkrcty. S.D.N.Y., filed January 26, 2004), at 14–17, 112–218.

<sup>16</sup> Guido A. Ferrarini and Paolo Giudici, “Financial Scandals and the Role of Private Enforcement: The Parmalat Case,” European Corporate Governance Institute Law Working Paper No. 40/2005, May 2005, <http://ssrn.com/abstract=730403>, at 11–12, 15–16, 37–38; David Reilly et al., “Parmalat Sues Bank of America Corp.,” *Wall Street Journal* (October 8, 2004), at A3; David Reilly and Alessandra Galloni, “Spilling Over: Top Banks Come Under Scrutiny for Role in Parmalat Scandal,” *Wall Street Journal* (September 28, 2004), at A1.

<sup>17</sup> Fein, *supra* note 8, § 3.05[G][21]; Christine Hurt, “Moral Hazard and the Initial Public Offering,” 26 *Cardozo Law Review* 711, at 755–58, 783–84 (2005); Sale, *supra* note 15, at 39–40; Arthur E. Wilmarth, Jr., “The OCC’s Preemption Rules Exceed the Agency’s Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection,” 23 *Annual Review of Banking and Financial Law* 244, at 348–49 (2004) [hereinafter Wilmarth, “OCC’s Preemption Rules”].

<sup>18</sup> Fein, *supra* note 8, §§ 3.05 [G][18], [20], and [25]; Sean J. Griffin, “A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings,” 69 *Brooklyn Law Review* 583, 592–96 (2004); Hurt, *supra* note 17, at 733–55.

<sup>19</sup> Fein, *supra* note 8, §§ 3.05[G][28], [29] and [37]; Paul G. Mahoney, “Manager-Investor Conflicts in Mutual Funds,” 18(2) *Journal of Economic Perspectives* (Spring 2004), at 161, 173–77; James B. McCallum, “Mutual Fund Market Timing: A Tale of Systemic Abuse and Executive Malfeasance,” 12 *Journal of Financial Regulation and Compliance* 170 (2004); Wilmarth, “OCC’s Preemption Rules,” *supra* note 17, at 349–51; “Mutual Funds: CIBC Subsidiaries Agree to Pay US\$125M for Alleged Facilitation of Trading Abuses,” 37 *Securities Regulation & Law Report* 1250 (2005) [hereinafter CIBC Pays].

<sup>20</sup> Randall Smith, “CIBC to Pay \$2.4 Billion over Enron,” *Wall Street Journal* (August 3, 2005), at A3 (incl. “Settling for More” tbl.); Tamsin Carlisle and Ann Davis, “CIBC’s Penalty for Enron Role Is US\$80 Million,” *Wall Street Journal* (December 23, 2003), at C1.

<sup>21</sup> David Boraks, “Will Regulatory Woes Produce Any Changes?” *American Banker* (December 27, 2004), at 1; Robin Sidel, “J.P. Morgan to Pay US\$2 Billion as Street’s Bill for Bubble Soars,” *Wall Street Journal* (March 17, 2005), at A1; CIBC Pays, *supra* note 19.

<sup>22</sup> See, e.g., Roger Lowenstein, *Origins of the Crash: The Great Bubble and Its Undoing*, at 97, 154–55, 174–75, 212–13 (New York: Penguin Press, 2004); Joseph Steiglitz, *The Roaring Nineties: A New History of the World’s Most Prosperous Decade*, at 87–88, 140–69, 348 n.12 (New York: W.W. Norton & Co., 2003); Robert Kuttner, “No Sainthood for Greenspan,” *Business Week* (August 1, 2005), at 106; Kevin Phillips, “How Wealth Defines Power: The Politics of the New Gilded Age,” *American Prospect* (May 2003), at A8; Eliot Spitzer and Andrew G. Celli, Jr., “Bull Run,” *New Republic* (March 22, 2004), at 18. See also Jacob M. Schlesinger, “What’s Wrong? The Deregulators: Did Washington Help Set Stage for Current Business Turmoil?” *Wall Street Journal* (October 17, 2002), at A1 (citing former Federal Reserve Board Chairman Paul Volcker’s belief that “the changes to Glass-Steagall, though inevitable, came without sufficient deliberation by policymakers”; previously, Volcker had opposed the Board’s 1987 decision to begin relaxing Glass-Steagall’s restrictions on bank underwriting of securities because he believed that the move “posed dangers” to both banks and their customers).

<sup>23</sup> Wilmarth, “Transformation,” *supra* note 5, at 220–22, 318–26, 332–38, 378–81.

<sup>24</sup> See *supra* note 8 and accompanying text.

<sup>25</sup> For discussions of the “real bills doctrine” followed by Glass, Willis, and other policymakers (including Adolph Miller, an economist who was an influential member of the Federal Reserve Board from its establishment in 1914 through 1936), see, for example, Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1960*, at 169, 191–93, 252–54, 407–11 (Princeton, N.J.: Princeton University Press, 1963); Allan H. Meltzer, *A History of the Federal Reserve, Volume I, 1913–1951*, at 70–71, 73–74, 138–39, 154–65, 186–88, 192–97, 245–50, 274–82, 398–400, 409–13 (Chicago: University of Chicago Press, 2003); W. Nelson Peach, *The Securities Affiliates of National Banks*, at 9–12, 169, 177 (Baltimore: The Johns Hopkins Press, 1941); Edwin J. Perkins, “The Divorce of



Commercial and Investment Banking: A History,” 88 *Banking Law Journal* 483, at 501–503 (1971).

<sup>26</sup> 77 Cong. Rec. 3725–26 (1933) (remarks of Sen. Glass); S. Rep. No. 73–77, at 8 (1933).

<sup>27</sup> See, e.g., S. Rep. No. 73–77, at 3–10 (1933); 77 Cong. Rec. 3725–26 (remarks of Sen. Glass); *id.* at 3835 (remarks of Rep. Steagall); *id.* at 3907 (remarks of Rep. Koppelman); *id.* at 4027–28 (remarks of Rep. Fish); 75 Cong. Rec. 9883 (1932) (remarks of Sen. Glass and Sen. Watson); *id.* at 9904, 9906 (1932) (remarks of Sen. Walcott and Sen. Dickinson); *id.* at 9910–13 (remarks of Sen. Bulkley).

<sup>28</sup> *Id.* at 3835.

<sup>29</sup> 75 Cong. Rec. 9904–9905 (1932) (remarks of Sen. Walcott).

<sup>30</sup> 77 Cong. Rec. 4028 (1933). See also 75 Cong. Rec. 9888 (1932) (remarks of Sen. Glass, alleging that securities affiliates of banks “were perhaps the greatest contributors to the riot of credit and inflation in 1928–29, with result that the country is now almost in an irreparable condition”).

<sup>31</sup> 75 Cong. Rec. 9911–13, 9914 (1932).

<sup>32</sup> *Id.* at 9914; see also 77 Cong. Rec. 3907 (1933) (similar remarks by Rep. Kopplemann).

<sup>33</sup> Operation of the National and Federal Reserve Banking Systems: Hearings on S. Res. 71 before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess. [hereinafter 1931 Hearings], Part 7 (App.), at 1063.

<sup>34</sup> *Id.* at 1064. The report noted that a “large New York institution” evidently purchased US\$5 million of foreign bonds from its securities affiliate during 1930. *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* The report also noted that securities affiliates of banks “show a much greater tendency to operate with borrowed funds than do [securities firms] which are independent of banks, the reason being that the identity of control and management which prevails between the bank and its affiliate tends to encourage reliance upon the lending facilities of the former.” *Id.* at 1058. In a 1971 decision, the U.S. Supreme Court reviewed the actual and potential conflicts of interest described by Senator Bulkley and the 1931 Senate staff

report. The Court characterized those conflicts of interest as being the “subtle hazards that arise when a commercial bank ... enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments.” *Investment Co. Institute v. Camp*, 401 U.S. 617, at 630–34 (1971) (quote at 630).

<sup>39</sup> For references to the collapse of Caldwell and Company, see, for example 1931 Hearings, *supra* note 33, Part 1, at 5–6, 18–19; *id.*, Part 5, at 633–35 (reprint of 1931 examination report of National Bank of Kentucky by the Comptroller of the Currency); 75 Cong. Rec. 9890 (1932) (remarks of Sen. Glass). For references to the failure of Bank of United States, see, for example, 1931 Hearings, *supra* note 33, Part 1, at 10, 116–17; *id.*, Part 7, at 1018, 1058–59, 1068; 75 Cong. Rec. 9905 (1932) (remarks of Sen. Walcott).

<sup>40</sup> See *infra* notes 176–84 and accompanying text.

<sup>41</sup> See 77 Cong. Rec. 3906 (1933) (remarks of Rep. Dingell); *id.* at 3940 (remarks of Rep. McGugin); *id.* at 4034–36 (remarks of Rep. Truax). See also *infra* notes 197–207 and accompanying text (discussing the failures of the Detroit and Cleveland banks).

<sup>42</sup> Vincent P. Carosso, *Investment Banking in America: A History*, at 348–53, 368–71 (Cambridge, Mass.: Harvard University Press, 1970); Peach, *supra* note 25, at 153–59; Perkins, *supra* note 25, at 510–24 (quoting Glass’s speech and noting that “[i]t was generally agreed to have been one of the most effective speeches of the [1932] campaign,” *id.* at 518–19); H. Parker Willis and John M. Chapman, *The Banking Situation*, at 84–102 (New York: Columbia University Press, 1934).

<sup>43</sup> Peach, *supra* note 25, at 159. See also, e.g., 77 Cong. Rec. 3835 (1933) (remarks of Rep. Steagall, stating that the “Glass bill ... finally passed [the Senate] without serious opposition”); *id.* at 4033 (remarks of Rep. Steagall, stating that “[e]verybody now regards these regulatory provisions [requiring banks to divest their securities operations] as wise and constructive”).

<sup>44</sup> 77 Cong. Rec. 3725 (1933); see also *id.* at 3726 (remarks of Sen. Glass, alleging that bank securities affiliates “were the most unscrupulous contributors, next to the debauch of the New York Stock Exchange, to the financial catastrophe which visited this country and was mainly responsible for the depression under which we have been suffering since”).

<sup>45</sup> Perkins, *supra* note 25, at 500.

<sup>46</sup> Raymond W. Goldsmith [né Goldschmidt], *The Changing Structure of American Banking*, at 87–88, 293 (tbl. 6), 297 (tbl. 11) (London: George Routledge & Sons, 1933). See also Wigmore, *supra* note 3, at 27 (reporting that loans on securities by banks and brokers “represented 18 percent of the

value of all listed stocks [in October 1929], an enormous proportion to be held on credit”).

<sup>47</sup> Wilmarth, “Financial Liberalization,” *supra* note 15, at 88–89.

<sup>48</sup> Act of Feb. 25, 1927, c. 191, § 2(b), 44 Stat. 1226. For discussions of the securities activities of banks prior to the McFadden Act, see Carosso, *supra* note 42, at 98–100, 129–31; Peach, *supra* note 25, at 16–21, 39–45, 50–51; Perkins, *supra* note 25, at 486–89; Willis and Chapman, *supra* note 42, at 176–81, 188–93, 206–13, 536–37. Congress understood that the McFadden Act would ratify “the right of national banks to continue to engage in the business of buying and selling investment securities. ... [T]his is a business regularly carried on by State banks and trust companies and has been engaged in by national banks for a number of years.” H.R. Rep. No. 69–83, at 3–4 (1926); S. Rep. No. 69–473, at 7 (1926).

<sup>49</sup> Peach, *supra* note 25, at 9–12, 45–51; Willis and Chapman, *supra* note 42, at 176–77, 536–37.

<sup>50</sup> Carosso, *supra* note 42, at 97–98, 235–36, 271–79; Peach, *supra* note 25, at 38–66, 143–59; Perkins, *supra* note 25, at 489–96; Willis and Chapman, *supra* note 42, at 181–87. In 1932, Senate investigators discovered an unpublished opinion prepared in 1911 and sent by Solicitor General Frederick Lehmann to Attorney General Charles Wickersham. The opinion declared that securities affiliates were unlawful under the National Bank Act. However, Wickersham did not take any formal action in response to Lehmann’s opinion. Peach, *supra* note 25, at 144–48; Perkins, *supra* note 25, at 517. During Senate floor debates in 1932, Senator Glass alleged that Lehmann’s opinion “clearly discloses ... that the activities of these affiliates are not only disastrous, as we now witness, but that they are absolutely illegal.” 75 Cong. Rec. 9888 (1932); *see also id.* at 9899–9904 (reprinting Lehmann’s opinion); *id.* at 10069–70 (further remarks of Sen. Glass regarding the Lehmann opinion).

<sup>51</sup> Carosso, *supra* note 42, at 224–29; Peach, *supra* note 25, at 31–33; Perkins, *supra* note 25, at 491.

<sup>52</sup> Peach, *supra* note 25, at 32–33.

<sup>53</sup> Carosso, *supra* note 42, at 228 (quoting Mitchell’s article published in *The Magazine of Wall Street* on June 9, 1917); Joel Seligman, *The Transformation of Wall Street*, at 24–25 (Boston: Northeastern University Press, 1995, rev. ed.).

<sup>54</sup> Edward Chancellor, *Devil Take the Hindmost: A History of Financial Speculation*, at 192–94 (New York: Farrar, Straus & Giroux, 1999) (footnotes omitted). For another colorful description of the optimism and specula-

tive spirit that pervaded the 1920s, see John K. Galbraith, *The Great Crash, 1929*, at 6–21, 57–61, 79–86 (Boston: Houghton Mifflin Co., 3rd ed. 1972).

<sup>55</sup> Carosso, *supra* note 42, at 240–45, 249–51; Chancellor, *supra* note 54, at 194–207.

<sup>56</sup> Carosso, *supra* note 42, at 251 (quoting article by Barnard Powers published in the *Magazine of Wall Street* on April 26, 1924).

<sup>57</sup> Harold van B. Cleveland and Thomas F. Huertas, *Citibank, 1812–1970*, at 128, 140–41 (Cambridge, Mass.: Harvard University Press, 1985); Goldsmith, *supra* note 46, at 55, 60–67; Peach, *supra* note 25, at 22–27.

<sup>58</sup> Barry Eichengreen and Krus Mitchener, “The Great Depression as a Credit Boom Gone Wrong,” Bank for International Settlements Working Paper No. 137, September 2003, <http://www.bis.org>, at 15–26, 42–45; Robert A. Gordon, “Cyclical Experience in the Interwar Period: The Investment Boom of the Twenties,” in *Conference on Business Cycles*, at 163, 206–15 (New York: National Bureau of Economic Research, 1951); Charles P. Kindleberger, *The World in Depression, 1929–1939*, at 44–46, 53–54, 59–61 (Berkeley: University of California Press, 1986, rev. ed.); Lionel Robbins, *The Great Depression*, at 30–54 (London: Macmillan & Co., 1934).

<sup>59</sup> Carosso, *supra* note 42, at 250 (quoting Moody’s report of January 8, 1925).

<sup>60</sup> *Id.* at 240–45, 249–51, 273; Cleveland and Huertas, *supra* note 57, at 135–41; Goldsmith, *supra* note 46, at 64–66, 130–34; Peach, *supra* note 25, at 24–25, 36–37; Perkins, *supra* note 25, at 493.

<sup>61</sup> Goldsmith, *supra* note 46, at 108, 126–39; Peach, *supra* note 25, at 28–31, 34–37, 71–72 (quote at 72); Perkins, *supra* note 25, at 488. *See also* Cleveland and Huertas, *supra* note 57, at 135 (explaining that “National City [Bank] ... wished to bring to each customer all things financial”); *id.* at 158 (quoting Charles Mitchell’s belief that “the trend [in banking] is always toward giving to a clientele a complete banking and investment and trust service”).

<sup>62</sup> Peach, *supra* note 25, at 83 (tbl. II).

<sup>63</sup> *Id.* at 109–10 (tbls. III & IV).

<sup>64</sup> *Id.* at 106–107; Carosso, *supra* note 42, at 283, 292, 331; Goldsmith, *supra* note 46, at 143–45; Peach, *supra* note 25, at 105–107; Randall S. Kroszner and Raghuram G. Rajan, “Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933,” 84 *American Economic Review* 810, at 813 (tbl. 2), 820–21 n.29 (1994); Terris

Moore, “Security Affiliate Versus Private Investment Banker—A Study in Security Originations,” 12 *Harvard Business Review* 478, at 482–83 (1934).

<sup>65</sup> Cleveland and Huertas, *supra* note 57, at 85–88, 123, 152–53; Peach, *supra* note 25, at 86–95.

<sup>66</sup> Peach, *supra* note 25, at 63–64, 67–68, 95–97.

<sup>67</sup> *Id.* at 58–70, 75–81, 98–104; *see also* Goldsmith, *supra* note 46, at 133–36.

<sup>68</sup> Carosso, *supra* note 42, at 279; *see also* Perkins, *supra* note 25, at 495 (stating that “commercial banks and their affiliates had become the dominant force in the investment banking field” by the end of the 1920s).

<sup>69</sup> Goldsmith, *supra* note 46, at 136–37. *See also* Peach, *supra* note 25, at 20 (stating that NCC “became the largest agency in the world for the distribution of securities to the public” during the late 1920s).

<sup>70</sup> Cleveland and Huertas, *supra* note 57, at 139, 140 (tbl. 8.1.), 141, 152–53.

<sup>71</sup> Peach, *supra* note 25, at 20–21, 28–31, 34–37, 74–76 (quotes at 37, 75); *see also* Carosso, *supra* note 46, at 273–80; Cleveland and Huertas, *supra* note 57, at 135–46.

<sup>72</sup> Carosso, *supra* note 42, at 275–76; *see also* Goldsmith, *supra* note 46, at 131–32 (stating that “the old private investment banking houses ... would not have been in a position to cope with [the] avalanche of new security issues” during the 1920s without the assistance of the securities affiliates of commercial banks); 1931 Hearings, *supra* note 33, at 539–40 (testimony of Allan M. Pope, stating that banks and their securities affiliates were essential participants in the “enormous increase in underwriting and distribution” of securities that took place during the 1920s, because banks provided extensive credit and their affiliates created large sales organizations to support the underwriting efforts of private investment houses); *supra* note 29 and accompanying text (citing Sen. Walcott’s similar view).

<sup>73</sup> Cleveland and Huertas, *supra* note 57, at 139, 141. *See also* Peter Rappaport and Eugene N. White, “Was There a Bubble in the 1929 Stock Market?” 53 *Journal of Economic History* 549, at 551 (1993) (noting that “[b]anks had a much broader customer base than traditional brokerage houses, and their securities affiliates sold stocks and bonds to many people who had little or no prior experience with investment in securities”).

<sup>74</sup> Peach, *supra* note 25, at 94 (stating that NCC maintained offices in more than 50 U.S. cities and several foreign cities and employed 350 salesmen in the United States alone).

<sup>75</sup> Seligman, *supra* note 53, at 24.

<sup>76</sup> Cleveland and Huertas, *supra* note 57, at 136 (quoting a lecture given by Mitchell to NCC employees in 1919).

<sup>77</sup> *Id.* at 136, 137.

<sup>78</sup> *Id.* at 138 (fig. 8.1) (reprint of NCC advertisement).

<sup>79</sup> *Id.* at 139 (quoting Mitchell's 1919 lecture to NCC employees).

<sup>80</sup> Seligman, *supra* note 53, at 24–25 (quoting telegram from Mitchell).

<sup>81</sup> Cleveland and Huertas, *supra* note 57, at 157. In 1930, Chase became “the largest private banking institution in the world” when it merged with the Equitable Trust Company. Peach, *supra* note 25, at 95.

<sup>82</sup> Wigmore, *supra* note 3, at 100.

<sup>83</sup> Seligman, *supra* note 53, at 25 (quoting Wilson's essay, “Sunshine Charley,” *New Republic*, June 28, 1933, at 59).

<sup>84</sup> Galbraith, *supra* note 54, at 42–43. At the time of Mitchell's public announcement, the Federal Reserve Board (the Board) and the Federal Reserve Bank of New York (the New York Bank) disagreed over the course of action that should be taken to discourage speculation in the stock market. The Board wanted to exert direct pressure on national banks and state banks that were members of the Federal Reserve, in order to persuade them to withhold credit for speculative purposes. Such direct pressure would have included a threat to deny discount privileges to any member bank that used such credit for the purpose of making loans on securities. On February 2, 1929, the Board warned the regional Federal Reserve Banks that they should not allow member banks to discount bills for the purpose of obtaining credit to make speculative loans on securities. Four days later, the Board issued a statement to the press warning about “the excessive amount of the country's credit absorbed in speculative security loans.” The New York Bank disagreed with both statements. The New York Bank opposed any direct controls on the use of credit and instead recommended that the discount rate be increased from 5 percent to 6 percent. Friedman and Schwartz, *supra* note 25, at 257–58.

The Board rejected the New York Bank's proposal, because (1) the Board did not want to raise the cost of credit for “legitimate commerce,” and (2) the Board believed that raising the discount rate by 1 percent would be a futile gesture and would not be effective in restraining the speculative activity occurring in the call loan market and the stock market. 1931 Senate Hearings, *supra* note 33, Part 1, at 142–44 (testimony of Gov. Adolph C. Miller of the Federal Reserve Board). It appears that Mitchell made his public announcement on March 25, 1929, stating that NCB would make available up

to US\$25 million of call loans, with the knowledge and at least the tacit support of George L. Harrison, governor of the New York Bank. However, Senator Glass publicly condemned Mitchell for “slapping the Federal Reserve Board squarely in the face.” Cleveland and Huertas, *supra* note 57, at 132–33, 383 n.57; Friedman and Schwartz, *supra* note 25, at 258–63.

<sup>85</sup> Galbraith, *supra* note 54, at 99.

<sup>86</sup> *Id.* at 105–20; *see also* Carosso, *supra* note 42, at 302–305; 1931 Hearings, *supra* note 33, Part 1, at 198–99 (testimony by Albert Wiggin, stating that the banker’s pool sought to support the stock market by purchasing “pivotal stocks,” which Wiggin defined as “active-market stocks”).

<sup>87</sup> Galbraith, *supra* note 54, at 119; *see also* Carosso, *supra* note 42, at 305 (stating that “[t]he reputation of the great bankers never recovered from the October quake”).

<sup>88</sup> 1931 Hearings, *supra* note 33, Part 1, at 190. Wiggin did not offer any specific prediction when Professor Willis asked, “How long will [the rebound] take?” *Id.*

<sup>89</sup> *Id.* at 191 (testimony of Albert Wiggin); *see also id.*, Part 2, at 298–99 (testimony of Charles Mitchell); *id.* at 404 (testimony of Melvin Traylor, chairman of the First National Bank of Chicago); *id.*, Part 3, at 539–43 (testimony of Allan Pope, Executive Vice President of the First National Old Colony Corp., a securities affiliate of the First National Bank of Boston).

<sup>90</sup> *Id.*, Part 2, at 295–96, 298 (colloquy between Sen. Walcott and Charles Mitchell). In his testimony before another Senate hearing in 1931, Mitchell acknowledged that “the policy of investment banking institutions” was “part of the machine that developed inflation” in the securities markets during the 1920s. However, he placed great emphasis on the demands of corporations and foreign countries for funds and the “obvious appetite on the part of the American public for investments.” Again, Mitchell cast investment bankers in a subordinate role, stating that they were “one of the tools by which the demands on each side operated to satisfy their requirements.” Cleveland and Huertas, *supra* note 57, at 175 (quoting Mitchell’s testimony).

<sup>91</sup> *See supra* note 76 and accompanying text (quoting Mitchell’s 1919 lecture to NCC employees).

<sup>92</sup> As discussed *infra* in the section entitled “The Pecora Committee’s Evidentiary Record,” the Pecora committee’s investigation identified a series of alleged abuses at NCB, Chase, and their securities affiliates. In addition, the investigation revealed that (1) in order to reduce his income taxes in late 1929, Mitchell created a “paper loss” of US\$2.8 million by selling NCB shares to his wife; and (2) Wiggin made US\$4 million in profits by making

short sales of Chase's stock following the crash of 1929. Carosso, *supra* note 42, at 330–35, 346–48; Seligman, *supra* note 53, at 23–30, 77–78.

<sup>93</sup> Carosso, *supra* note 42, at 243 (exh. 7).

<sup>94</sup> John B. McFerrin, *Caldwell and Company: A Southern Financial Empire* 9 (Nashville, Tenn.: Vanderbilt University Press, 1969 [1939]); Peach, *supra* note 25, at 37.

<sup>95</sup> Ilse Mintz, *Deterioration in the Quality of Foreign Bonds Issued in the United States, 1912–1930*, at 9 (tbl.1) (New York: National Bureau of Economic Research, 1951).

<sup>96</sup> Carosso, *supra* note 42, at 244 (exh. 8).

<sup>97</sup> Shiller, *supra* note 2, at 8–9; Wilmarth, “Financial Liberalization,” *supra* note 15, at 91.

<sup>98</sup> Galbraith, *supra* note 54, at 12–92; Shiller, *supra* note 2, at 6–9, 60–68, 82–88, 103–107, 156, 187–88, 192–95; J. Bradford DeLong and Andrei Shleifer, “The Stock Market Bubble of 1929: Evidence from Closed-End Mutual Funds,” 51 *Journal of Economic History* 675 (1991); Rappaport and White, *supra* note 73; Eugene N. White, “The Stock Market Boom and Crash of 1929 Revisited,” 4(2) *Journal of Economic Perspectives* 67 (Spring 1990) [hereinafter White, “Stock Market Boom”].

<sup>99</sup> Carosso, *supra* note 42, at 278–93; *id.* at 287 (exh. 12) (reporting that 591 investment trusts were organized during 1927–29); Goldsmith, *supra* note 46, at 130–37, 143–46.

<sup>100</sup> Carosso, *supra* note 42, at 242–85 (referring to the “veritable orgy of competition” that occurred between commercial banks and investment banking firms during the 1920s, *id.* at 255); *id.* at 243 (exh. 7) (showing that U.S. corporations issued US\$49 billion of debt and equity securities from 1919 to 1929, of which US\$16.3 billion were issued in 1928–29); George W. Edwards, *The Evolution of Finance Capitalism*, at 226–34 (New York: Augustus M. Kelley, 1967 reprint [1938]) [hereinafter Edwards, *Finance Capitalism*] (describing “overcompetition” resulting from the expansion of bank securities affiliates and the response of traditional securities firms, resulting in “the overissue of new securities” and “unsound selling practices”); Goldsmith, *supra* note 46, at 131–46 (describing investment trusts as “the weapon with which [the private investment banker] was able to counter the superior capital resources at the disposition of the security affiliates.” *Id.* at 143); White, “Stock Market Boom,” *supra* note 98, at 69–70 (stating that “the growth of the securities market, assisted by the establishment of investment trusts and securities affiliates,” attracted funds from “many ... new



investors [who] lacked experience in buying stock and monitoring firms, thus creating a favorable condition for a bubble”).

<sup>101</sup> Wigmore, *supra* note 3, at 637–43 (tbls. A.19, A.20)

<sup>102</sup> A 1933 study by George W. Edwards determined that 25.8 percent of domestic bonds issued during 1920–29 were in actual or pending default on December 31, 1931, including 31.7 percent of the bonds issued after 1926. Mintz, *supra* note 95, at 45–46 and tbl. 6 (summarizing the 1933 study by Edwards). A 1942 study by Edwards found that 30 percent of domestic corporate bond issues sold prior to the Glass-Steagall Act had defaulted by 1936. George W. Edwards, “The Myth of the Securities Affiliate,” 37 *Journal of the American Statistical Association* 225, at 225–26, 230 (1942) [hereinafter Edwards, “Securities Affiliate”]. Modern studies have produced similar results. See James S. Ang and Terry Richardson, “The Underwriting Experience of Commercial Bank Affiliates Prior to the Glass-Steagall Act: A Re-examination of Evidence for Passage of the Act,” 18 *Journal of Banking and Finance* 351, at 359, 363, 364 (tbl. 3) (1994) (finding that 21.1 percent of a sample of domestic corporate bonds issued from 1926 to 1930 (excluding utilities) defaulted by 1934, and 30.4 percent of such bonds defaulted by 1939); Manju Puri, “The Long-Term Default Performance of Bank Underwritten Securities Issues,” 18 *Journal of Banking and Finance* 397, at 400–401, 403 (tbl.1b) (1994) [hereinafter Puri, “Default Performance”] (finding that 19.2 percent of a sample of domestic industrial bonds issued from 1927 to 1929 defaulted within five years after their issue, and 28.6 percent of such bonds defaulted within seven years after their issue).

<sup>103</sup> The value of all NYSE-listed bonds fell from US\$47.4 billion in January 1931 to US\$30.6 billion in April 1933. George W. Edwards, “Control of the Security-Investment System,” 12 *Harvard Business Review* 1, at 4 (1933) [hereinafter Edwards, “Security-Investment System”]. In 1932, 56 percent of domestic corporate bonds (measured both in number of issues and in total face amounts) were trading at least 20 percent below their par values, and less than 6 percent of corporate bonds were trading at par or above. Lester V. Chandler, *America’s Greatest Depression, 1929–1941*, at 74 (tbl. 5–3) (New York: Harper & Row, 1970). Ang and Richardson found that a sample of domestic corporate bonds (excluding utilities) issued during the period 1926–30 had declined in value by more than 30 percent as of 1934, and by more than 50 percent as of 1939. Ang and Richardson, *supra* note 102, at 366–67, 368 (tbl. 5).

<sup>104</sup> Mintz, *supra* note 95, at 2 and n.3, 6, 33–34, 50–53.

<sup>105</sup> Willis and Chapman, *supra* note 42, at 199–201, 586–89. See Act of Feb. 25, 1927, § 16, 44 Stat. 1232 (authorizing national banks to make mortgage

loans with terms of up to five years); S. Rep. No. 69–473, at 11 (1926) (explaining that, prior to the 1927 statute, national banks could make mortgage loans with maturities of up to one year).

<sup>106</sup> Goldsmith, *supra* note 46, at 72–78, 293 (tbl. 6) (reporting that outstanding real estate loans made by all commercial banks increased from US\$1.4 billion to US\$5.0 billion during 1919–29); Willis and Chapman, *supra* note 42, at 591 (tbl. 133) (showing that outstanding real estate loans by national banks increased from US\$180 million to US\$1.5 billion during 1919–30).

<sup>107</sup> Chandler, *supra* note 103, at 8 (tbl. 1.5); Edwards, *Finance Capitalism*, *supra* note 100, at 244–46; Goldsmith, *supra* note 46, at 72–79, 105–106, 296 (tbl. 10); Benjamin Graham and David L. Dodd, *Security Analysis: Principles and Technique*, at 138–42, 741–42 n.19 (New York: McGraw-Hill Book Co., 2nd ed. 1940); Willis and Chapman, *supra* note 42, at 589, 591–609. *See also* Alexander J. Field, “Uncontrolled Land Development and the Duration of the Depression in the United States,” *52 Journal of Economic History* 785, at 786–87, 792–96, 799–801, 801 n.57 (1992).

<sup>108</sup> Chandler, *supra* note 103, at 16; Field, *supra* note 107, at 786–87, 795, 795 n.38; Goldsmith, *supra* note 46, at 77–79, 296 (tbl. 10); Gordon, *supra* note 58, at 201, 202 (tbl. 13), 203–207.

<sup>109</sup> S. Rep. No. 73–77, at 7 (1933); *see also* Goldsmith, *supra* note 46, at 79–81; Gordon, *supra* note 58, at 203–07; Willis and Chapman, *supra* note 42, at 606–09. Alexander Field found that the severely depressed real estate markets of the 1930s were produced by uncontrolled development and overbuilding during the 1920s, together with the fact that many housing subdivisions established during that decade were badly sited, poorly planned, and lacking in essential facilities (*e.g.*, adequate streets and utilities). Field, *supra* note 107, at 785–93, 798–803.

<sup>110</sup> Chandler, *supra* note 103, at 15–17; Cleveland and Huertas, *supra* note 57, at 120–21; Eichengreen and Mitchener, *supra* note 58, at 36–42 (concluding that a majority of consumer goods purchased during the 1920s were financed with consumer credit); Goldsmith, *supra* note 46, at 61–64, 66–67; Gordon, *supra* note 58, at 188–91, 196–97, 203–205; Martha L. Olney, “Avoiding Default: The Role of Credit in the Consumption Collapse of 1930,” *114 Quarterly Journal of Economics* 319, at 320–23 (1999).

<sup>111</sup> Charles W. Calomiris, “Financial Factors in the Great Depression,” *7(2) Journal of Economic Perspectives* (Spring 1993), at 61, 73, 75–76 (reporting that total U.S. long-term and short-term debts in 1929 were estimated at US\$234 billion, compared to total national income of US\$87 billion); Chandler, *supra* note 103, at 8 (tbl. 1–5 (estimating total U.S. private and public

debt in 1929 at US\$191 billion, with US\$30 billion being owed by federal, state, and local governments).

<sup>112</sup> Ben S. Bernanke, “Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression,” *73 American Economic Review* 257, at 260–61, 265–66, 270–74 (1983) [hereinafter Bernanke, “Nonmonetary Effects”]; Calomiris, *supra* note 111, at 73–79; Chandler, *supra* note 103, at 8–9, 69, 72–75; Olney, *supra* note 110, at 320, 323–33.

<sup>113</sup> Chandler, *supra* note 103, at 16.

<sup>114</sup> *Id.* at 15–16; Goldsmith, *supra* note 46, at 31–33.

<sup>115</sup> Field, *supra* note 107; Goldsmith, *supra* note 46, at 78–81; Gordon, *supra* note 58, at 203–207; Willis and Chapman, *supra* note 42, at 606–609; S. Rep. No. 73–77, at 3, 7.

<sup>116</sup> Chancellor, *supra* note 54, at 205–207; Eichengreen and Mitchener, *supra* note 58, at 42–45; Shiller, *supra* note 2, at 103–107; White, “Stock Market Boom,” *supra* note 98, at 70–71; Wigmore, *supra* note 3, at 54–56, 61–63, 66–71, 83–86; Willis and Chapman, *supra* note 42, at 614–15.

<sup>117</sup> Steven Klepper, “Firm Survival and the Evolution of Oligopoly,” *33 Rand Journal of Economics* 37, at 43–45, 57–58 (2002); *see also* White, “Stock Market Boom,” *supra* note 98, at 78 (noting that “high-tech firms and utilities, with no history of dividends and possibly brilliant futures, became favorites in the boom [of the 1920s] even though their fundamentals were difficult to assess”).

<sup>118</sup> Klepper, *supra* note 117, at 43–44.

<sup>119</sup> Eichengreen and Mitchener, *supra* note 58, at 42–44; Wigmore, *supra* note 3, at 61–63, 85–87.

<sup>120</sup> Gordon, *supra* note 58, at 177 (tbl. 5), 181–82, 190, 196, 208–209.

<sup>121</sup> *See* Carosso, *supra* note 42, at 243 (exh. 7); *supra* notes 60–86 and accompanying text.

<sup>122</sup> Chancellor, *supra* note 54, at 199–211; Eichengreen and Mitchener, *supra* note 58, at 21–26, 42–45; Goldsmith, *supra* note 46, at 95–96; Gordon, *supra* note 58, at 177 (tbl. 5), 181–82, 187–88, 201–13; Kindleberger, *supra* note 58, at 43–46, 53–54, 59–61, 95–97, 103–104; Robbins, *supra* note 58, at 30–31, 36–46, 69; White, “Stock Market Boom,” *supra* note 98, at 69–81. *See also* James D. Hamilton, “Monetary Factors in the Great Depression,” *19 Journal of Monetary Economics* 145, at 155 (1987) (noting that “10 percent of total gross private domestic investment during 1929 represented inventory accumulations”).

<sup>123</sup> Kindleberger, *supra* note 58, at 103–104; Christina D. Romer, “The Nation in Depression,” 7(2) *Journal of Economic Perspectives* (Spring 1993), at 19, 21, 26, 28 [hereinafter Romer, “Nation in Depression”].

<sup>124</sup> Romer, “Nation in Depression,” *supra* note 123, at 21–23, 29–31; *see also* Chandler, *supra* note 103, at 15–20, 21 (tbl. 2–1); Gordon, *supra* note 58, at 208–14; Kindleberger, *supra* note 58, at 103–07, 112–16; Christina D. Romer, “The Great Crash and the Onset of the Great Depression,” 105 *Quarterly Journal of Economics* 597 (1990) [hereinafter Romer, “Great Crash”].

<sup>125</sup> Calomiris, *supra* note 111, at 73–76; Chandler, *supra* note 103, at 15–20; Eichengreen and Mitchener, *supra* note 58, at 8–12, 16, 21–26, 30–45, 54–55; Friedman and Schwartz, *supra* note 25, at 240, 244–48, 305–308; Kindleberger, *supra* note 58, at 43–46, 53–54, 59–61, 95–97, 103–107, 112–16; Romer, “Great Crash,” *supra* note 124, at 597–99, 604–23; Romer, “Nation in Depression,” *supra* note 123, at 21–31.

<sup>126</sup> *See, e.g.*, C. D. Bremer, *American Bank Failures*, at 111–24 (New York: Columbia University Press, 1935); Carosso, *supra* note 42, at 253–65, 271–81, 297–99; Friedman and Schwartz, *supra* note 25, at 240, 244–48; Goldsmith, *supra* note 46, at 86–98, 103–107, 133–42; James S. Olson, *Saving Capitalism: The Reconstruction Finance Corporation and the New Deal, 1933–1940*, at 3–8 (Princeton, N.J.: Princeton University Press, 1988); Peach, *supra* note 25, at 103–14, 139–42; Robbins, *supra* note 58, at 30–31, 43–54, 61–63, 69–72; Willis and Chapman, *supra* note 42, at 525–47; O. K. Burrell, “Essential Elements in Banking Reconstruction,” 12 *Harvard Business Review* 12, at 14–15, 17–20 (1933); Edwards, “Security-Investment System,” *supra* note 103, at 4–8.

<sup>127</sup> *See* Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939*, at 190–93, 208–16 (New York: Oxford University Press, 1992); Eichengreen and Mitchener, *supra* note 58, at 3, 8–9, 21–24, 52; Friedman and Schwartz, *supra* note 25, at 240, 275, 287–89, 296; Goldsmith, *supra* note 46, at 35–36; Meltzer, *supra* note 25, at 170–78, 203–205, 252–54, 261–62; Robbins, *supra* note 58, at 44–54, 61–63; Peter Temin, *Lessons from the Great Depression*, at 19 (Cambridge, Mass.: MIT Press, 1989). Murray Rothbard has provided perhaps the strongest condemnation of the Federal Reserve’s monetary policies for being inflationary during the 1920s, particularly in 1924 and 1927. *See* Murray N. Rothbard, *America’s Great Depression*, at 104–45 (Kansas City, Mo.: Sheed & Ward, Inc., 3rd ed. 1975).

<sup>128</sup> As previously noted, during the period 1928–29 the Federal Reserve Board and the Federal Reserve Bank of New York carried on a prolonged

debate over whether the Federal Reserve should (1) apply direct pressure and other qualitative measures to discourage speculation in the stock market, or (2) use conventional open-market measures to restrain speculation such as raising the discount rate and selling government securities. See *supra* note 84 and accompanying text. Economists have generally concluded that (1) the Federal Reserve tried to curb speculation in the stock market by reducing the availability of credit for call money loans and other loans on securities, (2) the Federal Reserve's inconclusive actions in the period 1928–29 were not effective in preventing the final stages of the stock market boom, and (3) the Federal Reserve's actions created restrictive credit conditions in the general economy that triggered a recession in the summer of 1929. Eichengreen, *supra* note 127, at 216–26; Alexander J. Field, “A New Interpretation of the Onset of the Great Depression,” 44 *Journal of Economic History* 489 (1984); Friedman and Schwartz, *supra* note 25, at 254–66, 289–92, 297–98; Hamilton, *supra* note 122, at 145–49, 167–68; Meltzer, *supra* note 25, at 224–66; Romer, “Nation in Depression,” *supra* note 123, at 26–29; Temin, *supra* note 127, at 22–23.

<sup>129</sup> Ali Anari, James Kolari, and Joseph Mason, “Bank Asset Liquidation and the Propagation of the U.S. Great Depression,” 37 *Journal of Money, Credit and Banking* 753 (2005); Bernanke, “Nonmonetary Effects,” *supra* note 112; Ben S. Bernanke, “The Macroeconomics of the Great Depression: A Comparative Approach,” 27 *Journal of Money, Credit and Banking* 1, at 6–8, 12–20 (1995); Calomiris, *supra* note 111, at 68–73, 78–79; Eichengreen, *supra* note 127, at 249–53, 258–59, 293–98, 314–16, 323–29; Friedman and Schwartz, *supra* note 25, at 308–32, 342–59, 367–419; Kindleberger, *supra* note 58, at 128–30, 165–69, 182–96; Meltzer, *supra* note 25, at 271–413; Romer, “Nation in Depression,” *supra* note 123, at 32–34. Elmus Wicker has presented a somewhat different analysis of the banking panics of the Great Depression and the reasons for the Federal Reserve's lack of an effective response. Nevertheless, he believes that the Federal Reserve was at fault for failing to make aggressive open-market purchases of government securities in order to strengthen banks, restore depositor confidence, and prevent currency hoarding. See Elmus Wicker, *The Banking Panics of the Great Depression*, esp. at 17–23, 137–38, 151–65 (Cambridge, U.K.: Cambridge University Press, 1996).

<sup>130</sup> Perkins, *supra* note 25, at 498–503; 75 Cong. Rec. 9883–85 (1932) (remarks of Sen. Glass).

<sup>131</sup> See, e.g., Edwards, *Finance Capitalism*, *supra* note 100, at 223–35, 282–86; Robbins, *supra* note 58, at 30–31, 36–56, 61–63, 69; Willis and Chapman, *supra* note 42, at 178–82, 188–94, 525–37, 610–15, 630–33; S. Rep.

No. 73–77, at 2–7 (1933); *supra* notes 26–30 and accompanying text (discussing views of members of Congress).

<sup>132</sup> Eichengreen and Mitchener, *supra* note 58.

<sup>133</sup> Harold L. Cole, Lee E. Ohanian, and Ron Leung, “Deflation and the International Great Depression: A Productivity Puzzle,” National Bureau of Economic Research Working Paper No. 11237, <http://www.nber.org/papers/w11237>.

<sup>134</sup> *See, e.g.*, George J. Benston, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*, at 134–37 (New York: Oxford University Press, 1990); Jonathan R. Macey, “Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall,” 33 *Emory Law Journal* 1, at 15–21 (1984); Raghuram G. Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity*, at 220–24 (New York: Crown Books, 2003).

<sup>135</sup> *See, e.g.*, Fein, *supra* note 8, §§ 1.06 (intro.), 1.06[E], [F], and [G]; David Hosansky, “Cover Story: Paralyzed Congress on Sidelines in Financial Services Evolution,” 55 *Congressional Quarterly* 2292 (1997); Michael Schroeder, “It’s Alive: Why Glass-Steagall, Reviled for Decades, Just Won’t Go Away,” *Wall Street Journal* (April 10, 1998), at A1; Andrew Taylor, “Banking: Glass-Steagall Rewrite Stalls as Industry Foes Do Battle,” 54 *Congressional Quarterly* 539 (1996).

<sup>136</sup> Macey, *supra* note 134, at 17–18.

<sup>137</sup> *Operation of the National and Federal Reserve Banking Systems: Hearings on S. 4415 before the Senate Committee on Banking and Currency, 72nd Cong., 1st Sess. (1932) [hereinafter 1932 Hearings], Part 1, at 17 (quote), 24–30, 40–41.* Pope had presented similar testimony in opposition to an earlier version of the Glass bill in 1931, when he was a member of the board of governors of the IBA. However, in 1931 Pope said that he was appearing “in the capacity of a private individual” and not speaking for the IBA. 1931 Hearings, *supra* note 33, Part 3, at 539–41; *see also supra* note 72 (quoting Pope’s 1931 testimony against the Glass bill).

<sup>138</sup> 1932 Hearings, *supra* note 137, Part 1, at 25, 40.

<sup>139</sup> *Id.* at 27.

<sup>140</sup> Donald C. Langevoort, “Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation,” 85 *Michigan Law Review* 672, at 697 (1987).

<sup>141</sup> 1932 Hearings, *supra* note 137, at 16, 37 (testimony of Mr. Pope).

<sup>142</sup> *Id.*

<sup>143</sup> Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance*, at 353–55, 376–77 (New York: Simon & Schuster, 1990).

<sup>144</sup> *Id.* at 354–55.

<sup>145</sup> Seligman, *supra* note 53, at 19. Similarly, the Democratic Party’s 1932 platform called for the “severance of affiliated securities from, and the divorce of the investment banking business from, commercial banks.” Perkins, *supra* note 25, at 518.

<sup>146</sup> Carosso, *supra* note 42, at 372–75; Chernow, *supra* note 143, at 374–77, 384–89; Perkins, *supra* note 25, at 167–68. *See infra* notes 149–53 and accompanying text (discussing the enactment of § 21 of the Glass-Steagall Act). According to an estimate published in the *Literary Digest* in 1934, about two-thirds of private banks chose to stay in the securities business despite the hardships involved in giving up their deposit-taking function. The loss of deposits was a serious blow to private banks, because it made them more dependent on loans from commercial banks. Carosso, *supra* note 42, at 372.

<sup>147</sup> Carosso, *supra* note 42, at 289–91, 317–20, 325–26, 328–29, 336–46; Chernow, *supra* note 143, at 359–74; Seligman, *supra* note 53, at 21–23, 31–37; Robert Sobel, *The Life and Times of Dillon Read*, at 86–91, 173–89 (New York: Truman Talley Books, 1991).

<sup>148</sup> Seligman, *supra* note 53, at 31–38 (quote at 37), 65–72; *see also* Carosso, *supra* note 42, at 339–51; Chernow, *supra* note 143, at 362–74; Sobel, *supra* note 147, at 187–88.

<sup>149</sup> Act of June 16, 1933, c. 89, § 21(a)(1), 48 Stat. 189.

<sup>150</sup> 77 Cong. Rec. 4179 (1933); *see also id.* at 4178 (text of Tydings’s proposed amendment).

<sup>151</sup> *Id.* (remarks of Sen. Bulkley); *id.* at 4179–80 (remarks of Sen. Glass). Officials of Chase’s securities affiliate ultimately created First Boston in conjunction with officers of First National Bank of Boston’s securities affiliate. Chernow, *supra* note 143, at 375; Peach, *supra* note 25, at 165–66.

After defeating the Tydings amendment, Bulkley persuaded the Senate to adopt an amendment that expanded the scope of Section 21 so that it would encompass any person or firm engaged in the business of securities underwriting or distribution. The original version of Section 21 applied only to persons engaged “principally” in that business. Bulkley argued that “some of the great investment houses are engaged in so many forms of business that

there is some doubt as to whether the investment business is the principal one.” Accordingly, he convinced the Senate to delete the word “principally” in order to “accomplish a separation of the investment and deposit banking [business].” 77 Cong. Rec. 4180 (1933).

<sup>152</sup> Langevoort, *supra* note 140, at 697; *see also* Carosso, *supra* note 42, at 372.

<sup>153</sup> Glass maintained close personal relationships with two J.P. Morgan partners—Russell Leffingwell and Parker Gilbert—who served as his deputies during his tenure as Secretary of the Treasury in the Wilson administration. In July 1933, a month after the enactment of Glass-Steagall, Glass sent a private letter to Leffingwell stating that the Roosevelt administration had forced him to accept Section 21 at the urging of Winthrop Aldrich, the new president of Chase. Chernow, *supra* note 143, at 355, 374–75, 751 n.86. However, Glass’s position as portrayed in his private letter clearly seems inconsistent with his vigorous public defense of Section 21 and his strong opposition to the Tydings amendment during the Senate debates on May 25, 1933.

<sup>154</sup> Langevoort, *supra* note 140, at 693–97 (quote at 696).

<sup>155</sup> S. Rep. No. 74–1007, at 16 (1935); 79 Cong. Rec. 11933–34 (1935) (remarks of Sen. Glass).

<sup>156</sup> 79 Cong. Rec. 11933 (1935).

<sup>157</sup> 79 Cong. Rec. 11932–33 (1935). LaFollette also claimed that the problem with U.S. industrial companies was not a lack of adequate financing. He contended that, during the 1920s, firms had built production facilities that far exceeded the demand for their goods. *Id.* at 11934.

<sup>158</sup> H.R. Rep. No. 74–1822, at 53 (1935) (Conf. Rep.); 79 Cong. Rec. 13706 (1935) (remarks of Rep. Steagall). Representative Steagall announced to the House of Representatives that Glass’s proposal had been removed from the conference report. That announcement was greeted with applause, indicating that House members strongly supported the maintenance of a strict separation between commercial and investment banking. *Id.*

<sup>159</sup> Benston, *supra* note 134, at 41.

<sup>160</sup> Eugene N. White, “Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks,” 23 *Explorations in Economic History* 33, at 52 (1986) [hereinafter White, “Glass-Steagall Act”]. For Benston’s discussion of White’s study, *see* Benston, *supra* note 134, at 32–34.

<sup>161</sup> White, “Glass-Steagall Act,” *supra* note 160, at 40.



<sup>162</sup> *Id.* (discussing advantages of greater diversification connected with size); Charles W. Calomiris and Joseph R. Mason, “Fundamentals, Panics, and Bank Distress During the Depression,” 93 *American Economic Review* 1615, at 1630–31 (2003) (same); Chandler, *supra* note 103, at 79–82 (discussing shifts of deposits from smaller to larger banks); Wigmore, *supra* note 3, at 121–22 (same); *infra* notes 183, 186, 190, 195–96, 211, and accompanying text (discussing support received by large troubled banks during 1930–33).

<sup>163</sup> White, “Glass-Steagall,” *supra* note 160, at 40–42. White also performed regressions indicating that the presence of a securities affiliate did not have an adverse effect on bank capital or liquidity. For a discussion of the failure or near-failure of several large banks with securities affiliates during 1930, 1932, and 1933, see *infra* the section entitled “The Failures of Several Key Banks with Securities Affiliates.”

<sup>164</sup> Chandler, *supra* note 103, at 73; Goldsmith, *supra* note 46, at 79–84; Wicker, *supra* note 129, at 16; Wigmore, *supra* note 3, at 228–29, 308, 317, 430–31; Willis and Chapman, *supra* note 42, at 596–609. *See also* Mintz, *supra* note 95, at 46–48 (describing R. J. Saulnier’s study of urban mortgage lending by life insurance companies, which found that, by the end of 1934, lenders had foreclosed on 24 percent of mortgages made from 1920 to 1924 and on 41 percent of mortgages made from 1925 to 1929).

<sup>165</sup> *See supra* notes 102–104 and accompanying text; *see also* Goldsmith, *supra* note 46, at 106 (reporting that, during the period 1931–32, market values for bonds declined by the following percentages: 36 percent for railroad bonds, 27 percent for public utility bonds, 22 percent for industrial bonds, 45 percent for foreign bonds, and 10 percent for U.S. government securities).

<sup>166</sup> Mintz, *supra* note 95, at 51–52 (incl. tbl. 9)

<sup>167</sup> Willis and Chapman, *supra* note 42, at 537–40 (describing study of 34 failed New York state banks); Robert G. Rodkey, “State Bank Failures in Michigan,” 7 *Michigan Business Studies* 101, at 101–102, 130–39 (1935–36) (presenting study of 163 failed Michigan state banks).

<sup>168</sup> Goldsmith, *supra* note 46, at 302 (tbl. 16) (showing that Federal Reserve member banks reported losses of US\$470 million in their securities portfolios during the period 1929–31, compared with US\$630 million of loan losses); Wicker, *supra* note 129, at 13–14 (showing that, during the period 1929–32, member banks reported US\$6.84 of losses for every US\$100 of securities investments, compared with US\$5.09 of losses for every US\$100 of loans).

<sup>169</sup> Calomiris and Mason, *supra* note 162, at 1630–33.

<sup>170</sup> Bremer, *supra* note 126, at 115–18; Goldsmith, *supra* note 46, at 105–106, 190–91; Wigmore, *supra* note 3, at 122–23.

<sup>171</sup> Mintz, *supra* note 95, at 83–84; 1931 Hearings, *supra* note 33, Part 3, at 501–03 (testimony of Prof. Marcus Nadler).

<sup>172</sup> See, e.g., 75 Cong. Rec. 9883 (1932) (remarks of Sen. Glass, declaring that “the great banks in the money centers choked the portfolios of their correspondent banks from Maine to California with utterly worthless investment securities”); *id.* at 9910 (remarks of Sen. Bulkley, stating that “the correspondent relationship ... furnished a peculiarly inviting system of distribution” for bank securities affiliates and investment banks, because country banks “were dependent either on their city correspondents or on private distributing houses for advice in the selection of investments”); 77 Cong. Rec. 3835 (1933) (remarks of Rep. Steagall); 77 Cong. Rec. 4176 (1933) (remarks of Sen. Wheeler, citing a Montana bank that failed due to losses on bonds it purchased from J.P. Morgan and other “big banks”); Goldsmith, *supra* note 46, at 106, 190–91 (stating that “the small bank inevitably became the victim of security salesmen’s offers and selling talks”).

<sup>173</sup> Eugene N. White, *The Regulation and Reform of the American Banking System, 1900–1929*, at 99–106, 149–51 (Princeton, N.J.: Princeton University Press, 1983); 75 Cong. Rec. 9882–83 (1932) (remarks of Sen. Glass).

<sup>174</sup> 1931 Hearings, *supra* note 33, at 542.

<sup>175</sup> 1932 Hearings, *supra* note 137, at 30. See also 75 Cong. Rec. 9883 (1932) (remarks of Senators Glass and Norris, alleging that federal bank regulators and examiners encouraged country banks to invest in risky securities to improve their performance).

<sup>176</sup> McFerrin, *supra* note 94, at 116–40.

<sup>177</sup> *Id.* at 119–25, 150–61.

<sup>178</sup> *Id.* at 176–88; Goldsmith, *supra* note 46, at 225–26; Kindleberger, *supra* note 58, at 130; Wicker, *supra* note 129, at 32–36, 52–55.

<sup>179</sup> Morris R. Werner, *Little Napoleons and Dummy Directors: Being the Narrative of the Bank of United States*, at 62–63 (New York: Harper & Brothers, 1933).

<sup>180</sup> *Id.* at 26–31, 93–130; Paul B. Trescott, “The Failure of the Bank of United States, 1930,” 24 *Journal of Money, Credit and Banking* 384, at 386–91 (1992).

<sup>181</sup> Susan E. Kennedy, *The Banking Crisis of 1933*, at 2–4 (Lexington, Ky.: University Press of Kentucky, 1973); Trescott, *supra* note 180, at 391–95; Werner, *supra* note 179, at 135–39, 185–87.

<sup>182</sup> Cleveland and Huertas, *supra* note 57, at 166, 395–96 nn.28–32; Friedman and Schwartz, *supra* note 25, at 309–10 n.9; Werner, *supra* note 179, at 197–208.

<sup>183</sup> Friedman and Schwartz, *supra* note 25, at 309–10 n.9; Goldsmith, *supra* note 46, at 227; Wigmore, *supra* note 3, at 125, 128.

<sup>184</sup> Cleveland and Huertas, *supra* note 57, at 166–67, 397 nn.34–35; Friedman and Schwartz, *supra* note 25, at 308–13; Trescott, *supra* note 180, at 385–86; Wicker, *supra* note 129, at 36–39, 49–52, 55–59 (questioning the macroeconomic significance of BUS’s failure, but acknowledging that the Federal Reserve “was not successful in restoring depositor confidence after the crisis had subsided,” *id.* at 59).

<sup>185</sup> Goldsmith, *supra* note 46, at 173–76; F. Cyril James, *The Growth of Chicago Banks*, at 942–67 (New York: Harper & Brothers, 1938); Wicker, *supra* note 129, at 69–70.

<sup>186</sup> Goldsmith, *supra* note 46, at 229–30; James, *supra* note 185, at 958–62, 996–1006; Wicker, *supra* note 129, at 70, 86.

<sup>187</sup> Richard D. Cudahy and William D. Henderson, “From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons,” 26 *Energy Law Journal* 35, at 51–69 (2005); James, *supra* note 185, at 1030–31; Arthur R. Taylor, “Losses to the Public in the Insull Collapse,” 36 *Business History Review* 188, at 188–95 (1962) (estimating that when liquidation of the Insull empire was completed in 1948, investors suffered a net loss of US\$638 million, equal to 24 percent of their original investment of US\$2.65 billion); Wigmore, *supra* note 3, at 152–54, 344–48; *Stock Exchange Practices: Hearings on S. Res. 84 and S. Res. 239 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 72 Cong., 2nd Sess., Part 5, at 1530–33, 1684–87, 1693–99, 1741–42 (1933).

<sup>188</sup> Charles W. Calomiris and Joseph R. Mason, “Contagion and Bank Failures During the Great Depression: The June 1932 Chicago Banking Panic,” 87 *American Economic Review* 863, at 867–68 (1997); Wigmore, *supra* note 3, at 406–407.

<sup>189</sup> James, *supra* note 185, at 1031–38; Jesse H. Jones with Edward Angly, *Fifty Billion Dollars: My Thirteen Years with the RFC (1932–1945)*, at 73–75 (New York: Macmillan Co., 1951); Wicker, *supra* note 129, at 112–14.

<sup>190</sup> Goldsmith, *supra* note 46, at 175–76; James, *supra* note 185, at 1038–40; Jones, *supra* note 189, at 74–81; Wicker, *supra* note 129, at 114; Wigmore, *supra* note 3, at 321; *Reconstruction Finance Corp. v. Central Republic Trust Co.*, 17 F. Supp. 263, 267–83, 295–301 (N.D. Ill. 1936).

<sup>191</sup> Cleveland and Huertas, *supra* note 57, at 171–72, 402 nn.61–62; Friedman and Schwartz, *supra* note 25, at 325, 330–31 n.43; James, *supra* note 185, at 1044–46; Joseph R. Mason, “Do Lender of Last Resort Policies Matter? The Effects of Reconstruction Finance Corporation Assistance to Banks During the Great Depression,” 20 *Journal of Financial Services Research* 77, at 77–78, 87–91 (2001); Joseph R. Mason, “Reconstruction Finance Corporation Assistance to Financial Intermediaries and Commercial and Industrial Enterprises in the United States, 1932–37,” in Stijn Claessens et al., eds., *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws* 167, at 172–78 (Washington: World Bank, 2001) [hereinafter Mason, “RFC Assistance”]; Olson, *supra* note 126, at 26–29, 67–68; Wigmore, *supra* note 3, at 321–25.

<sup>192</sup> Goldsmith, *supra* note 46, at 195–98; Marquis James and Bessie R. James, *Biography of a Bank: The Story of Bank of America N.T. & S.A.*, at 142–43, 176–77, 193–204, 222–34, 268–78, 288–312 (New York: Harper and Brothers, 1954); Donald L. Kemmerer, *The Life of John E. Ravensky: Banker and Industrialist*, at 145–46 (Champaign, Ill.: Stipes Publishers, Ltd., 1977).

<sup>193</sup> Goldsmith, *supra* note 46, at 197–99; James and James, *supra* note 192, at 269–70 (explaining that Bancitaly Corp., the predecessor of Transamerica, was similar to an “investment trust” because it purchased the stocks of U.S. banks, railroads, industrial corporations, and European banks); *id.* at 281–90 (reporting that Bancitaly spent US\$60 million in purchasing Bank of America’s stock to stop a “bear raid” during 1928, resulting in a loss to Bancitaly of about US\$20 million); *id.* at 291–92 (describing the creation of Transamerica in 1929, to take over the business of Bancitaly); *id.* at 303 (stating that Transamerica purchased Occidental Life Insurance Co. and the controlling stock interest in General Foods in 1930); Kemmerer, *supra* note 192, at 160 (stating that Transamerica “bought all kinds of stock” on margin).

<sup>194</sup> Cleveland and Huertas, *supra* note 57, at 169; Goldsmith, *supra* note 46, at 199–200; James and James, *supra* note 192, at 313–31; Kemmerer, *supra* note 192, at 160–64; Wigmore, *supra* note 3, at 160, 253–54.

<sup>195</sup> James and James, *supra* note 192, at 331–58; Wigmore, *supra* note 3, at 318, 354 (stating that, despite Giannini’s rehabilitation program, “Bank of America at year end [1932] was still the most illiquid of the big banks”).

<sup>196</sup> Kennedy, *supra* note 181, at 39–42; Mason, “RFC Assistance,” *supra* note 191, at 177 (tbl. 8.1).

<sup>197</sup> Chancellor, *supra* note 54, at 208; Goldsmith, *supra* note 46, at 168–69, 204–205; Kennedy, *supra* note 181, at 77–80; Olson, *supra* note 126, at 28; Peach, *supra* note 25, at 100–03, 118; Ferdinand Pecora, *Wall Street Under Oath: The Story of Our Modern Money Changers*, at 234–36, 241–47 (New York: Augustus M. Kelley Publishers, 1968 [1939]); Wicker, *supra* note 129, at 117–18; Wigmore, *supra* note 3, at 51, 120–21, 434–36.

<sup>198</sup> Chandler, *supra* note 103, at 37–38, 44; Jones, *supra* note 189, at 55–57; Wigmore, *supra* note 3, at 276, 374, 407.

<sup>199</sup> Wigmore, *supra* note 3, at 437–48, 442 (tbl. 13.1, showing that Guardian National Bank of Commerce had foreclosed on almost one-third of its mortgage loans by March 1933).

<sup>200</sup> Wigmore, *supra* note 3, at 435–36, 442 (tbl. 13.1, showing that, by March 1933, Guardian National Bank of Commerce had incurred US\$2 billion in losses from depreciated or defaulted bonds and had US\$5.8 billion of “doubtful” loans to its securities affiliate); *Stock Exchange Practices: Hearings on S. Res. 84 Before the Senate Comm. on Banking and Commerce*, 73d Cong., 1st Sess. (1933) [hereinafter 1933 Hearings], Part 9, at 4388–89 (quotation from testimony by Robert Lord), 3890–95, 4508, 4612, 4620–22, 4634, 4638–39.

<sup>201</sup> Detroit Bankers wrote down its assets by US\$22 million at the end of 1931 to reflect the declining value of its securities investments. 1933 Hearings, *supra* note 200, Part 11, at 5166–67, 5174, 5183–84. The parent holding company also suffered US\$7 million in losses on bank stocks that it acquired from a securities affiliate in order to prevent that affiliate’s bankruptcy. *Id.* at 5095–5106; *id.*, Part 12, at 5533.

<sup>202</sup> Jones, *supra* note 189, at 59–69; Kennedy, *supra* note 181, at 82–102, 193–95; James S. Olson, *Herbert Hoover and the Reconstruction Finance Corporation, 1931–1933*, at 102–104 (Ames, Iowa: Iowa State University Press, 1977); Wigmore, *supra* note 3, at 438–43.

<sup>203</sup> Goldsmith, *supra* note 46, at 171, 236; Jones, *supra* note 189, at 69; Wigmore, *supra* note 3, at 444–46.

<sup>204</sup> 1933 Hearings, *supra* note 200, Part 18, at 7982–85, 8013–17, 8019, 8054–57, 8123–28, 8189–95.

<sup>205</sup> *Id.* at 7987, 7994–95, 8013, 8017–22, 8087–89, 8123–25, 8132–33, 8139–41, 8255–59.

<sup>206</sup> *Id.* at 8025–28, 8146–57, 8251–53.

<sup>207</sup> Goldsmith, *supra* note 46, at 238–39; Jones, *supra* note 189, at 69–71; Olson, *supra* note 126, at 28–29; Wicker, *supra* note 129, at 121, 126–29.

<sup>208</sup> Peach, *supra* note 25, at 92–98 (reporting that NCB, Chase, and Continental Illinois operated the first, second, and fourth largest securities affiliates as of 1930).

<sup>209</sup> Cleveland and Huertas, *supra* note 57, at 159–61, 171, 191, 390 n.44, 391–92 n.4.

<sup>210</sup> Goldsmith, *supra* note 46, at 140; Peach, *supra* note 25, at 133–39; Wigmore, *supra* note 3, at 173–75, 220–21, 238, 357–58, 468.

<sup>211</sup> James, *supra* note 185, at 1087–90; Jones, *supra* note 189, at 47–49; Olson, *supra* note 126, at 125–26.

<sup>212</sup> Cleveland and Huertas, *supra* note 57, at 191; Jones, *supra* note 189, at 35–36.

<sup>213</sup> Cyril B. Upham and Edwin Lamke, *Closed and Distressed Banks: A Study in Public Administration*, at 238 (Washington: Brookings Institution, 1934).

<sup>214</sup> Olson, *supra* note 126, at 82.

<sup>215</sup> Jones, *supra* note 189, at 34.

<sup>216</sup> Friedman and Schwartz, *supra* note 25, at 427; Mason, “RFC Assistance,” *supra* note 191, at 185–92; Olson, *supra* note 126, at 78–82.

<sup>217</sup> Wigmore, *supra* note 3, at 468, 470. *See also* Anthony Saunders and Berry Wilson, “An Analysis of Bank Charter Value and Its Risk-Constraining Incentives,” 19 *Journal of Financial Services Research* 185, at 193–94 (2001) (finding that banks with the highest charter values during the 1920s, based on the market value of their equity, had the highest systematic asset risk and showed the greatest loss in their charter values during the period 1930–34).

<sup>218</sup> For example, when Continental Illinois offered to sell preferred stock to its own shareholders in connection with its sale of preferred stock to the RFC, its shareholders subscribed for only US\$333 of the stock. Wigmore, *supra* note 3, at 468.

<sup>219</sup> Charles W. Calomiris and Berry Wilson, “Bank Capital and Portfolio Management: The 1930s ‘Capital Crunch’ and the Scramble to Shed Risk,” 77 *Journal of Business* 421, at 422, 452 (2004).

<sup>220</sup> Olson, *supra* note 126, at 82 (reporting that bank loans fell from US\$38.1 billion to US\$20.3 billion during the period 1931–35, while the percentage

of bank funds invested in government securities rose from 21 percent to 58 percent during 1929–34). *See also* Cleveland and Huertas, *supra* note 57, at 199 (stating that NCB increased its liquidity ratio—*i.e.*, the ratio of government securities and excess reserves to deposits—from 40 percent to 60 percent during the period 1934–35).

<sup>221</sup> *See* Friedman and Schwartz, *supra* note 25, at 449–62; Olson, *supra* note 126, at 82, 103, 128–34, 168–80, 221–25.

<sup>222</sup> Rajan and Zingales, *supra* note 134, at 223.

<sup>223</sup> Benston, *supra* note 134, at 107.

<sup>224</sup> Edwards, “Securities Affiliate,” *supra* note 102, at 230–32 (comparing domestic corporate bonds underwritten by commercial bank affiliates and investment banks); Moore, *supra* note 64, at 483–84 (comparing securities underwritten by the eight largest commercial bank affiliates and the eight largest investment banks during 1921–32).

<sup>225</sup> Ang and Richardson, *supra* note 102, at 365–75, 383–86 (comparing performance of domestic corporate bonds and foreign bonds underwritten by commercial bank affiliates and investment banks from 1926 to 1930); Kroszner and Rajan, *supra* note 64, at 817–22, 829–30 (comparing performance of domestic industrial bonds underwritten by commercial bank affiliates and investment banks from 1921 to 1929); Puri, “Default Performance,” *supra* note 102, at 401–15 (comparing performance of domestic industrial bonds and preferred stock and foreign government bonds underwritten by commercial bank affiliates and investment banks during the period 1927–29).

<sup>226</sup> Puri, “Default Performance,” *supra* note 102, at 399 (quote), 415; *see also* Benston, *supra* note 134, at 131–32 (citing evidence indicating that a significantly higher percentage of U.S. corporate bonds underwritten by NCB’s affiliate during the period 1928–33 received investment grade ratings, in comparison to other domestic corporate bonds issued during that period); Kroszner and Rajan, *supra* note 64, at 824–26, 829–30; Manju Puri, “Commercial Banks in Investment Banking: Conflict of Interest or Certification Role?” 40 *Journal of Financial Economics* 373, at 375–76, 379–85, 397 (1996) [hereinafter Puri, “Commercial Banks”].

<sup>227</sup> Puri, “Commercial Banks,” *supra* note 226, at 385 (quote), 388–89. *See also supra* notes 29, at 71–73, and accompanying text (explaining that the distribution networks established by commercial bank affiliates made them highly desirable as participants in the securities underwriting market).

<sup>228</sup> Ang and Richardson, *supra* note 102, at 363–65.

<sup>229</sup> *Id.* (finding that the default record for bonds underwritten by affiliates of NCB and Chase was inferior to the performance of other commercial bank affiliates and about the same as the performance of investment banks); Puri, “Default Performance,” *supra* note 102, at 405–13 (concluding that the overall default record for securities underwritten by affiliates of NCB and Chase was inferior to the comparable performance of all other underwriters). For evidence that J.P. Morgan and Kuhn, Loeb were the leading private investment bankers during the 1920s, see, e.g., Carosso, *supra* note 42, at 255–57; Wigmore, *supra* note 3, at 106. Peach concluded that the securities affiliates of NCB and Chase were “the two most important security affiliates in existence” at that time. Peach, *supra* note 25, at 114; see also *id.* at 63–64, 92–98; Chernow, *supra* note 143, at 304; Cleveland and Huertas, *supra* note 57, at 141–53; *supra* note 67 and accompanying text.

<sup>230</sup> Ang and Richardson, *supra* note 102, at 374–83 (quote at 383).

<sup>231</sup> See *supra* the sections entitled “Congress’s Repudiation of Universal Banking in the Glass-Steagall Act of 1933”; “Bank Involvement in the Securities and Credit Markets Helped to Produce an Unsustainable Economic Boom During the 1920s”; and “Were Traditional Securities Firms Supporters or Intended Beneficiaries of the Glass-Steagall Act?”; Langevoort, *supra* note 140, at 693–97; Peach, *supra* note 25, at 139–42, 151–53, 169–79; Perkins, *supra* note 25, at 498–503, 518–19, 526; S. Rep. No. 73–77, at 3–10 (1933). The anti-speculative intent of the Banking Act of 1933 was also reflected in provisions that authorized Federal Reserve banks to prevent member banks from using discount window loans to finance speculation in securities. Meltzer, *supra* note 25, at 434; S. Rep. No. 73–77, at 9, 13, 14.

<sup>232</sup> See *supra* notes 147–51 and accompanying text.

<sup>233</sup> Carosso, *supra* note 42, at 349–68, 375–84; Seligman, *supra* note 53, at 35–38, 51–100, 122–23, 127–32, 222–31.

<sup>234</sup> See *supra* notes 150–54 and accompanying text.

<sup>235</sup> Peach, *supra* note 25, at 141–42, 151–53, 175–79; Perkins, *supra* note 25, at 498–503, 518–19, 526.

<sup>236</sup> Benston, *supra* note 134, at 43–44.

<sup>237</sup> *Id.* at 107; see also *id.* at 208; *supra* note 223 and accompanying text.

<sup>238</sup> Rajan and Zingales, *supra* note 134, at 223, 335 n.55.

<sup>239</sup> Peach, *supra* note 25, at 113; see also *id.* at 114 (stating that “[i]nformation concerning these [abuses and defects] is limited largely to the extensive Senate investigation of stock exchange practices. A substantial portion of this investigation dealt with the activities of” NCC and CSC.).



<sup>240</sup> *Id.* at 113.

<sup>241</sup> *Id.* at 114–15; *see also* Carosso, *supra* note 42, at 261–63; Mintz, *supra* note 95, at 63–85.

<sup>242</sup> Peach, *supra* note 25, at 115–16; *see also* Carosso, *supra* note 42, at 330–31; Kennedy, *supra* note 181, at 119–20; Seligman, *supra* note 53, at 26–28.

<sup>243</sup> Peach, *supra* note 25, at 116–26; *see also* Carosso, *supra* note 42, at 331–32, 346; Kennedy, *supra* note 181, at 120–21; Seligman, *supra* note 53, at 28–29.

<sup>244</sup> For a description of alleged abuses involving officers of NCC and CSC, *see* Peach, *supra* note 25, at 127–30; Carosso, *supra* note 42, at 333–35, 346–47; Kennedy, *supra* note 181, at 123–25; Seligman, *supra* note 53, at 26, 77–78.

<sup>245</sup> Peach, *supra* note 25, at 131–33; *see also* Carosso, *supra* note 42, at 333; Kennedy, *supra* note 181, at 119.

<sup>246</sup> Peach, *supra* note 25, at 131–39.

<sup>247</sup> Wigmore, *supra* note 3, at 173–75, 332, 357; *see supra* note 210 and accompanying text.

<sup>248</sup> *See supra* note 209 and accompanying text.

<sup>249</sup> *See supra* notes 177–81, 187–90, and accompanying text.

<sup>250</sup> Peach, *supra* note 25, at 142, 175.

<sup>251</sup> Cleveland and Huertas, *supra* note 57, at 156.

<sup>252</sup> *Id.* at 157–58.

<sup>253</sup> *Id.* at 158.

<sup>254</sup> *Id.* at 158, 402 n.60 (quoting Mitchell’s remarks presented on Jan. 10, 1933).

<sup>255</sup> Peach, *supra* note 25, at 72 (quote), 141–42, 175–76; *see also* Goldsmith, *supra* note 46, at 108, 128–42.

<sup>256</sup> *See, e.g.*, Wilmarth, “Transformation,” *supra* note 5, at 223–25, 303–04, 326–30, 411–13, 446–50, 454–57, 472–76.

<sup>257</sup> *See, e.g.*, Ben Bernanke and Harold James, “The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison,” in R. Glenn Hubbard, ed., *Financial Markets and Financial Crises* 33, at 55 (Chicago: University of Chicago Press, 1991); Richard S. Grossman, “The Shoe That Didn’t Drop: Explaining Banking Stability Dur-

ing the Great Depression,” 54 *Journal of Economic History* 654, at 673–74 (1994); Isabel Schnabel, “The German Twin Crisis of 1931,” 64 *Journal of Economic History* (2004), at 822 *passim*; and the following papers published in Charles H. Feinstein, ed., *Banking, Currency, and Finance in Europe Between the Wars* (Oxford, U.K.: Clarendon Press, 1995): Charles H. Feinstein, Peter Temin, and Gianni Toniolo, “International Economic Organization: Banking, Finance, and Trade in Europe Between the Wars,” at 9, 20–23, 35, 38–40, 45; Joost Jonker and Jan Luiten van Zanden, “Method in the Madness? Banking Crises Between the Wars, an International Comparison,” at 77, 81–86, 90–91; Michel Lescure, “Banking in France in the Inter-War Period,” at 315, 317–18, 330–31; Fritz Weber, “From Imperial to Regional Banking: The Austrian Banking System, 1918–1938,” at 338 *passim*; Forrest Capie, “Commercial Banking in Britain Between the Wars,” at 396 *passim*.

<sup>258</sup> See, e.g., the papers by Jonker and van Zanden and by Capie, cited *supra* in note 257; Perkins, *supra* note 25, at 526–27.

<sup>259</sup> For discussions of the boom-and-bust cycle in Japan’s economy between 1985 and 2000, see, for example, Michael D. Bordo and Oliver Jeanne, “Boom-Busts in Asset Prices, Economic Instability, and Monetary Policy,” National Bureau of Economic Research Working Paper 8966, June 2002, at 3–7, 18–19; Elaine Browne, “Does Japan Offer Any Lessons for the United States?” 2001(3) *New England Economic Review* (Federal Reserve Bank of Boston), at 3; Mitsuhiro Fukao, “Japan’s Lost Decade and Its Financial System,” 26(3) *World Economy* (March 2003), at 365 *passim*; Takeo Hoshi and Anil K. Kashyap, “Japan’s Financial Crisis and Economic Stagnation,” 18(1) *Journal of Economic Perspectives* (Spring 2004), at 3 *passim*; Ryoichi Mikitani, “The Nature of the Japanese Financial Crisis,” in Ryoichi Mikitani and Adam S. Posen, eds., *Japan’s Financial Crisis and Its Parallels to U.S. Experience*, at 27 *passim* (Washington: Brookings Institution for International Economics, 2000); Yoshinori Shimizu, “Convoy Regulation, Bank Management, and the Financial Crisis in Japan,” in *id.* at 57 *passim*; Wilmarth, “Financial Liberalization,” *supra* note 15, at 79–80, 97 n.4; Bill Emmott, “The Sun Also Rises: A Survey of Japan,” *The Economist* (October 8, 2005) (beginning after p. 58); Yuka Hayashi, “Lenders Lift Japan’s Prospects: Banks’ Incipient Revival Is Pivotal to Embarking on Growth Cycle,” *Wall Street Journal* (August 16, 2005), at A14; “Japan’s Banks: Genesis,” *The Economist* (September 10, 2005), at 68.

<sup>260</sup> See *supra* notes 15–22 and accompanying text.

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**Lessons Learned from the Failure of  
Market Discipline and Regulatory  
Lapses: How to Prevent Future Busts**

LYNN TURNER

One of the things that distinguishes wise individuals from those who may be intellectually superior, but not as wise, is the ability to avoid repeating one's mistakes. Inherently, this also encompasses the ability to forecast or see changes as they unfold, and then adapt to them. In a way, wise people are much like the top athletes who constantly study film to find deficiencies in their form, no matter how small, and then correct them. Likewise, those who fail to learn from their mistakes and repeat them will, sooner or later, find themselves on the sidelines, no matter how talented.

With that in mind, I would like to address some of the lessons we have seen and experienced in recent years. Certainly, the Enrons in the United States, the Parmalats of Europe, and the failed financial reporting of financial institutions in Asia all provide more than ample opportunities for study. Since they all involve human behavior, it is no surprise that lessons are universal and global in nature.

We have experienced corporate boards that became entrenched and attached to imperial Chief Executive Officers (CEOs). We have seen management who took the cash but failed to deliver performance. In some cases, the CEOs and Chief Financial Officers (CFOs) knowingly lied to the owners they worked for, seeing them more as servants than as investors. And time and time again, gatekeepers have failed to provide warnings to investors despite their knowledge of improper conduct.

When it came to Wall Street, the Chinese walls designed to protect investors crumbled and, in fact, resemble the Great Wall of China today, where little of the original is left standing. Investment bankers lined their pockets at the expense of those whose money they took, while doling out favors to those who would return them in kind. Ana-

lysts hyped stocks of dot-coms whose lives in some cases turned out to be shorter than that of a bad movie.

And we found that financial engineers were not second to their electrical counterparts. Indeed, financial engineers dreamed up new products that would not only dodge the rules intended to provide transparency, but they also generated large sums of fees for which one could be handsomely rewarded. Professionals such as the accountants and attorneys were only too willing to stick their hand in the cookie jar as well when they saw the financial rewards for such behavior.

### **Lessons Learned**

What are some of the lessons that have been learned? In no particular order 10 come to mind.

The first lesson is the realization that financial incentives, such as stock options, can create both good and bad behavior. We witnessed throughout the 1990s how incentives fostered innovation, economic expansion, building of plants, and the accompanying creation of jobs. Yet, at the same time, when left to their own devices, some people believed the incentives created an environment in which the end came to justify the means, even if that end could ultimately inflict tremendous personal and economic damage to thousands of others. And what of all that wealth the stock options supposedly created for technology investors when the NASDAQ raced to 5200? Where is it today and what have those options done in recent years to create value for shareholders?

Second, in major systemic market breakdowns, including that accompanying the depression of the 1930s, the bear market of the 1970s, as well as the bubble of the 1990s, many observed that the whole orchard of market participants is not rotten to the core. Yet at the same time, such widespread failures are not the result of a few bad apples either. Rather they tend to be the result of a few bad actors that initially crossed over the line of ethical conduct. This created an uneven and sometimes lucrative playing field, and others followed.

The third lesson is that the capital markets may be efficient in the longer run, but in the short term, they can be highly ineffective. For example, securities markets can react very quickly to new information about the value of securities—often anticipating new facts before they are made public. At the same time, the price of the security should reflect all available information to participants in the markets. Due in large part to improvements in technology, information has become easy—and inexpensive—to obtain and process. However, evidence shows that stock prices react with substantial volatility immediately following significant announcements that impact the company. Such short-term price fluctuations do not reflect the underlying fundamentals of the value of the stock and do not demonstrate an efficient market.

Fourth, the lack of timely, high-quality transparency with respect to what is creating or destroying value greatly contributes to inefficient markets. This is especially true when the shortcoming is used to mask real economic conditions and performance of companies. While there is a cost to transparency, especially to those who are responsible for providing it, the lack of transparency can have a much greater cost (and benefit) to those who use the information to make informed decisions. Without transparency, investors, creditors, and regulators cannot make reasoned decisions and, ultimately, make wrong decisions, leading to poor allocation of capital. Ultimately, that has always led to national or international economic consequences. The importance of transparency also applies to accounting and financial disclosure standards. We have learned that standards that are the result of compromises to meet the needs of preparers—to the detriment of the ultimate customers, investors, and creditors—are neither principle-based nor reflective of the true economics of the business.

Markets can discipline market participants, but only if the market can measure and hold those responsible accountable. Therefore, the fifth lesson is that one successfully manages only what one can measure. In order for the market to measure accountability for each and every market participant, be it public companies, investment funds, stock exchanges, or regulators, there must be high-quality disclosures of financial performance and those indicators that are critical to the success of the enterprise. Without these disclosures on a comparable, consistent, and timely basis, the market cannot provide

discipline in an effective and efficient manner. As a result, management fails to measure in terms of economic reality that which must be managed; operational issues that need fixing in the business fail to get fixed; the numbers get managed by management as a way of fixing the problem; and in the end, to the surprise of many, the business implodes and is no longer capable of being fixed by management and fails.

Sixth, in order to provide oversight and counterbalances to financial incentives that may create a negative incentive for some, the necessary role of gatekeepers has been created. Independent auditors have been empowered to provide a third party perspective of the financial statements and accompanying disclosures. The legal professionals provide their expert opinion on the legality of transactions and filings with regulators and investors. And investment bankers are required to perform a level of due diligence as a sort of sanity check, if you will, with respect to their undertakings. Yet the very financial incentives that create the need for these gatekeepers can also compromise their ability to perform their function. The ethics of these market participants are not without challenges and potential for breakdown, which in turn can have disastrous effects well beyond market participants.

The seventh lesson may well be the most critical and important lesson one can learn when it comes to capital markets. It is the simple and yet powerful and self-evident concept of independence. Independence is vital and critical to the success of any functioning market system. When the independence of corporate boards, gatekeepers, stock exchanges, analysts, investment bankers, accounting standard setters, or regulators is compromised, at best a weak link in the chain is created. But all too often, the markets deflate as if a balloon pricked by a sharp pin.

Often it has been argued that market participants, such as the major auditing or Wall Street investment banking firms, are not willing to compromise their reputations and independence in exchange for fees. Yet that is exactly what occurred during the bubble as names like Merrill Lynch, JPMorgan Chase, CitiGroup, Putnam, Janus, and

each of the Big Five accounting firms became household names tarnished by repeated negative exposure in the media.

In addition, members of the accounting profession have referred to there being a lack of empirical evidence demonstrating that the large consulting fees they took—US\$2.69 for each dollar of audit fees in 2000—impacted their judgments. Yet time and time again at the Securities and Exchange Commission (SEC), situations such as at Waste Management were observed, where the auditors found the problems, and then failed to report them, instead choosing to give the company a clean bill of health. As Paul Volcker once said at a roundtable discussion, “You do not need studies to figure this one out.” Yet defining independence is a struggle as financial incentives push some to fight for weaker independence regulations, while others push for unquestionable rules. However, it is in the mind and ethics of the decision maker that the answer will ultimately rest. Only time will provide the ultimate proof.

The next lesson is that politics and transparency are like oil and water. They don’t mix. When politicians, whose political machines are “well oiled” by special interests, place special interests ahead of transparency for investors in the form of full and fair disclosure, trouble is just around the corner. Such actions are like a film of sludge covering what would otherwise be transparent, clear like a glass of fresh water. It is beyond question that some politicians in the United States directly contributed to the systemic breakdown that permitted the bubble in our markets toward the end of the 1990s.

The ninth lesson is that capital markets are not “self-healing.” The very real existence of inherent financial conflicts, a lack of independence, and political interference prevent and inhibit capital markets from taking self-correcting actions. In the United States, businesses, auditors, analysts, corporate boards, and others had been urged to adopt best practices, sometimes for decades. For example, the organization of Financial Executives International had for many years urged its members to report on internal controls, consistent with recommendations of highly respected commissions arising from debacles in the 1970s and 1980s. These same executives had been urged to address the shortcomings of their “pro forma” earnings releases that included



everything but the bad stuff. During 2000, the SEC urged and pushed the profession, along with a panel of experts led by the former chairman of Pricewaterhouse, to adopt more effective and stringent oversight. And of course, our own Financial Accounting Standards Board (FASB) had been working on a project that would have solved the accounting for special purpose entities such as existed at Enron for over two decades.

Yet none of these solutions came to fruition. Instead, one out of every 10 public companies in the United States has had to restate its financial statements after shortcomings in their internal controls were exposed, the off-balance sheet transactions of companies such as Enron and Parmalat surprised investors, and investors were misled by earnings numbers that were more representative of Grimm's fairy tales than economic truth. Billion dollar errors in financial statements have become a recurring rather than an extraordinary event.

The final lesson is that when there is a lack of enforcement of rules, be it those regarding conduct on Wall Street or the major international stock markets, the independence of gatekeepers or corporate boards, the transparency of financial disclosures, or the ethics of management, there are in fact and substance no such rules. Time and time again, rules have been ignored when management believed the benefits of such behavior outweighed the costs associated with ethical and proper conduct. It has been like a speeding car whose driver had seen the sign, "Next policeman—500 miles." And with trade becoming more global with each new day, perhaps the sign might more appropriately say, "Next policeman an ocean away."

To date, in some countries, change has and continues to occur. Here in the United States, public sentiment, illustrated clearly in polls, led politicians to pass what has affectionately become known as Sarbanes-Oxley. Change is also occurring internationally as we have seen new rules and regulations passed and/or proposed in countries such as Italy, England, Germany, Canada, and Australia. We have seen the Organization for Economic Cooperation and Development adopt new measures, and likewise, the International Accounting Standards Board has also adopted new measures, such as those requiring expensing of all forms of compensation. The International

Organization of Security Regulators has also been working hard to facilitate greater coordination among its members, including in the field of enforcement.

But whether these measures and steps taken ultimately receive a passing grade will depend on whether, in time, they resolve the matrix of inherent financial conflicts, lack of independence, lack of transparency, and accountability by bringing them clearly into the sunlight through high-quality disclosures. Just as people like financial rewards, they also tend to guard their reputations with zeal. Quite often, they act with more ethical behavior when the risk of getting caught with one's picture plastered on the front page of a major national or international newspaper increases. As the weekly newspaper in Aspen, Colorado succinctly touts, "If you don't want it printed, don't let it happen."

To that end, the discussion will next address some of the factors required for a passing grade. These factors focus on the issues of independence, accountability, adequate controls and oversight, and effective enforcement of those who chose to break the law.

### **Changes to Prevent Future Busts**

First, in the area of corporate governance, boards need to govern with investors clearly in mind. To that end, corporate boards need to become more independent of the CEOs they oversee. The days of the "good old boys' club" of board members needs to become as much a relic of the past as the dotcoms and the horse and buggy. That is not to say professional board members are required. But we do need experienced, knowledgeable members who ask tough questions, and when the answer isn't satisfactory, they ask them again and again until the answer is complete. To help accomplish this, corporate boards should be 75 percent or more independent, and the roles of the chairman and CEO should be separated. Such practices have become more commonplace elsewhere than in the United States and I think we need to follow the lead of others. As for mutual funds, as the Securities and Exchange Commission has proposed, the chairman of the board should always be independent of the fund complex whose fees come from the investor funds.

Second, to help ensure greater accountability of executives, the executives should have to formally acknowledge their accountability for the truth, the whole truth, and nothing but the truth when they provide information to the owners and creditors of a business.

Third, accountability should be established and the progress measured through greater transparency in disclosures to a greater extent than is currently done. We should eliminate gimmicks that exist in current international and national accounting standards that permit lease and other forms of financings to remain off-balance sheet. Changes in the value of financial portfolios, liabilities, and instruments should all be reflected without compromise in the financial statements. The international and national accounting standard setters need to adopt a rule that, notwithstanding their existing standards, if material information is necessary to an understanding of a business, and that information is not required by a particular rule, then that information must still be disclosed. Key performance indicators, which provide investors, creditors, and regulators greater visibility into the future value creation or destruction for a business, should also become a standard part of any disclosure regime.

Some argue for the creation of differing levels of transparency for businesses or countries based on their size or degree of development. Yet neither of those two criteria have anything to do with the ability of investors to make reasoned, informed decisions about how to best allocate their capital to maximize their returns. And while I do agree a small business may be less complex than a large multinational conglomerate, it should nonetheless be very transparent with respect to its disclosures. For example, if it has financial instruments, leases, or pension plans, it should disclose those and their economic impact on the business in a truthful, meaningful fashion. To waive such a requirement is to take the first step away from a principles-based approach toward a complex set of rules based on exemptions, waivers, and a lack of reality.

Companies and countries that provide transparent disclosures, which serve investors in their quest to maximize returns, will increasingly be able to attract capital at an increasingly attractive price. It is just such a system that allows investors over the long run to maximize

their returns and reduce their losses, thereby increasing their trust and confidence.

Fourth, an alignment and linking of executives' pay to their performance on behalf of investors must be done over the long run. In all likelihood, this means changing the mix of some forms of compensation, such as decreasing the use of stock options and increasing the use of restricted stock that vests over time and, in some cases, after retirement. It also means measuring performance not on a quarter-by-quarter basis, but by how each of those quarters builds on the long-term strategy of the business. Likewise, if we are to hold executives responsible for their performance over the long run, then investors must also change how they perceive and measure performance. In particular, portfolio managers at institutional investors should also adjust their compensation schemes to compensate them for their performance over the long run.

Fifth, we need to reduce the financial conflicts inherent in a robust capital market system by increasing the independence of the gatekeepers and overseers. As previously discussed, corporate boards need to become more independent. Likewise, auditors whose reputations have been bloodied and bludgeoned by the disclosure of one financial fraud after another need to become more independent. After all, if auditors cannot find billion-dollar errors as existed at WorldCom, Parmalat, and Qwest, or report a serious deficiency to investors and regulators when it is reportably found, such as at Tyco, Waste Management, or Adelphia, what is reasonable to expect them to be able to find and report? Perhaps the need for periodic mandatory rotation of auditors has come.

Restoration of the public's trust in the auditing profession and firms will be accomplished only if they are prohibited from providing services that conflict with their independence, both in fact and appearance. It is common sense: an auditor of a company who audits his or her own work, who acts as an advocate for the company or executives they are responsible for testing, who acts in any capacity as an employee or management, or who has a financial interest or business dealing with the company will have their independence seriously challenged by just about any reasonably prudent investor. To that

end, auditors should be prohibited from engaging in such acts. While some have proposed letting the auditors themselves decide if there is a threat to their independence and then put in place safeguards, experience in recent years demonstrates that this type of approach has failed. The auditors seldom see a threat, seeing dollars instead, and before long their job is over, but the company's problems are just beginning.

Yet independence should not be just a lesson for auditors. The objectivity of other gatekeepers such as financial analysts and the legal profession need to be enhanced and strengthened as well. In the United States, 10 investment banks were the subject of a large legal and financial settlement with the SEC and the Attorney General of the State of New York. However, that settlement only applied to those 10 firms, not the thousands of others that have been left to continue their past practices. The reality is that, with the financial rewards being as large as they are, systems involving ethics and regulations need to be put in place and then strictly enforced to ensure analysts do their homework, and then provide independent and timely research to investors. This is an area where much work remains to be done in the United States.

At the same time, we are debating the role of the legal profession in the financial scandals. The general counsel for Tyco is on trial, while counsel at Parmalat is under investigation. Corporate counsel and their roles at companies such as Enron, WorldCom, and Spiegel have also come under scrutiny. While members of the legal profession may have a role to act as staunch advocates for their clients, they are nonetheless the one profession in the business of justice. Accordingly, wise minds must find a way to ensure the profession serves justice and not just those who sign the checks.

Sixth, the independence of those who make the rules, be it accounting standard setters or regulators, needs to be paramount and unquestioned. Those responsible for the independence of the standard setters must protect it with the passion of a zealot. This is an unending task as observed today with certain European financial institutions and the European Commission compromising the principles of the IASB when it comes to reporting financial instruments. Likewise, the

high-technology industry and some members of the U.S. Congress are attempting to compromise the Financial Accounting Standards Board in its quest to require expensing of stock options. Yet we have seen all too clearly in the United States what the costs are to the capital markets when independence is lost and congressional votes are sold to the highest bidder.

Seventh, investors should have a voice in the corporate boardroom of underperforming companies when the executives and boards become entrenched and unresponsive. In those situations, the investors in the company should be permitted to nominate their own slate of directors, using the same resources and processes available to management and the board. By giving the investors a chance to institute change in those limited situations, it creates an incentive for companies to fulfill their obligations to their investors.

Eighth, adequate internal controls are necessary to ensure the accuracy and adequacy of disclosures, as well as compliance with all laws and regulations. In the United States, such controls were mandated by legislation adopted in 1977 after disclosure of hundreds of corporations engaging in improper payments. When hundreds of financial institutions failed in this country in the 1980s, costing the taxpayers roughly one-half trillion dollars, they were required not only to have the controls in place and operating, but also to have their independent auditors test and report on them.

More recently, with over one out of every 10 companies having to redo their financial statements, the U.S. Congress has once again required companies to have their internal controls in place, operating effectively with both management and the independent auditor reporting on those controls to the investing public and regulators. Surprisingly, the Financial Executives International has long urged companies to report on their internal controls to their investors. However, that sound recommendation fell for the most part on deaf ears. Indeed, based on the whining we have heard from some in the business community here, one wonders just how many companies have had effective systems of internal controls in place. While businessmen have complained about the costs they are incurring to make their internal controls adequate to provide information necessary for investors, and quite frankly for successful management of the company,

those same businessmen fail to note the hundreds of billions of dollars lost by investors, and the resulting impact on our economy. While they say legislation should “do no harm” to business, they have failed miserably to ensure business does no harm to investors.

Ninth, we need to see stronger enforcement in all areas affecting the financial markets. From enforcement of accounting, auditing, and disclosure rules, to independence standards, ethical conduct, and fiduciary responsibilities of boards and gatekeepers, law enforcement agencies need to take more timely and rigorous action against those who fail in their legal or fiduciary responsibilities to investors. When laws are broken, action needs to be taken promptly so as to keep a level playing field for those who chose to play by the rules.

As many global businesses have a significant portion of their operations outside of the country they are domiciled in, the regulators need to find ways to more effectively and efficiently cooperate and prosecute illegal behavior when it occurs. It is no longer acceptable in a global society for one regulator alone to investigate and prosecute cases such as Enron, Parmalat, Shell, or Nortel. Those who chose to ignore the law need to understand that the policeman is just around the corner.

This also means that those who fail in their obligations and responsibilities should not be given immunity from penalties associated with their behavior. For example, in some countries the accounting profession has asked for limits to their exposure to lawsuits by those who have suffered damages, including when the auditors failed in their professional responsibilities. Indeed, the European Commissioner, Fritz Bolkenstein, has noted that exposure to that liability does have an impact on auditors when they contemplate the work they need to perform. If an auditor is able to escape meaningful responsibility for the product, one can only wonder what the quality of the product will be in the future.

Tenth, finally and foremost, the mission of those responsible for the capital markets must be based on and driven, just as it is with every successful business, by the quality of the product needed and desired by the end customer. When a business fails to deliver a product its customers demand, it becomes a dinosaur. Likewise, in a glob

ally connected world of international trade, finances, and markets, those who deliver the highest quality product to investors will become the successes of the future. Those who do not will become extinct.



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## **VII. BANKING AND TECHNOLOGY**

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ANITA RAMASASTRY

In 1996, journalists and other pundits predicted the death of cash and the emergence of a brave new world of electronic money and payments. An article in the *New York Times Magazine* boasted that “cash is dirty, inefficient and obsolete. ‘Smart’ cards, digital cash and a host of electronic currencies will soon replace pocket money.”<sup>1</sup> This prediction was more hyperbole than reality. Cash is still being used and the use of electronic money globally currently trails cash and other traditional noncash payment instruments.<sup>2</sup>

Electronic money (e-money) loosely refers to many different types of substitutes for physical cash that allow for value to be stored electronically and for payment using the value to be made electronically.<sup>3</sup> The Bank for International Settlements defines e-money as “stored-value or prepaid product in which a record of the funds or value available to the consumer for multipurpose use is stored on an electronic device in the consumer’s possession.”<sup>4</sup>

At present, some of the most popular examples of e-money schemes have involved limited purpose prepaid card programs. In these programs, nonbanks issue cards to consumers to make niche, small-value purchases. Examples include coffee cards, retail gift cards, and public transit cards.<sup>5</sup>

The United States and the member states of the European Union regulate nonbank issuers of e-money. This chapter will explain how nonbank e-money schemes and related forms of electronic payments<sup>6</sup> are regulated in the United States and the European Union. The focus of the discussion is on prudential regulation of nonbank issuers of e-money. Much of the innovation in the area of e-money has occurred in the nonbank sector. The chapter examines the competing regulatory regimes in the European Union and the United States and exam-

ines both legal frameworks to see if regulation has been an incentive or a hindrance to innovation and growth of e-money in either market.

This chapter determines that both regulatory regimes have specific legal impediments that might appear to hinder the growth of e-money in the nonbank sector. At present, however, there is little data that shows a correlation between legal requirements and slower rate of e-money adoption in either the European Union or the United States. Rather, factors such as lack of consumer demand, payment culture, and the availability of other convenient forms of retail payments may in fact be greater predictors of the popularity of e-money regimes in both regions.

### **What Is Electronic Money?**

E-money first emerged during the 1990s as part of the growth of the Internet for commercial transactions.<sup>7</sup> The first wave of electronic payments focused on the concept of an electronic purse or wallet, which a consumer could load with electronic “value” as an alternative to using physical cash. Consumers might also make purchases with stored-value cards—plastic cards on which value was recorded.

Both electronic purses and stored-value cards were meant to facilitate commerce (both online and offline) as the means of payment became more portable. “Digital coins,” for example, were meant to be stored in an electronic wallet, and consumers would be able to purchase small-value items such as recipes or download newspaper articles with ease. Such small-value purchases are referred to as “micropayments.”

Despite much fanfare, many of the early e-money schemes of the 1990s failed or faded out of existence. There was a lack of uptake in the European and U.S. marketplace for early generation electronic purses and stored-value cards.<sup>8</sup>

At the same time, the potential advent of e-money caused regulators to examine the possible safety and soundness risks posed by nonbank issuers of e-money. Regulators began to ask questions about whether those who issued digital coins or other types of e-money were posing a safety and soundness risk to consumers who purchased

such products and whether a corresponding systemic risk existed in the marketplace more generally.<sup>9</sup>

The perceived risks associated with e-money related to the fact that nonbank issuers of e-money would be entrusted with customer funds, held until e-money was redeemed or moved out of a particular system. If the e-money issuer became insolvent, absent a prudential framework, customers would become general unsecured creditors of the issuer. In the United States and Europe, some financial sector regulators advocated limiting issuance of electronic money solely to financial institutions.<sup>10</sup> One of the questions asked was whether nonbank issuers were “accepting deposits” and thus required to be licensed as a financial institution.<sup>11</sup>

During the early twenty-first century, a resurgence of e-money has occurred. Internet funds transfer systems such as PayPal, prepaid consumer gift cards (for purchasing coffee or cell phone services), and services offered via mobile phones are part of the new wave of e-money products and services.<sup>12</sup> While the emerging marketplace is still developing, regulators continue to assess regulatory efforts in the e-money and e-payments area in an effort to find the right level of regulation that will encourage payments innovation.

What are some of the different types of electronic money or payments that might be classified as “e-money”? The following summary provides a high-level overview of the array of products that have been identified as e-money or some form of Internet/electronic payments. Each of the categories listed below has been offered, at some point, by nonbanks. Financial services regulators in the United States and in Europe continue to assess and grapple with the issue of which types of e-money schemes should be regulated and which should be exempt—because of their limited scope or because they pose minimal risk to consumers.

### **E-Money and Internet Payment Mechanisms**

Certain types of electronic payments or Internet payment mechanisms have been referred to by commentators by a host of different names including electronic cash, digital cash, electronic currency, and Internet or online scrip. E-money refers to money or a money substitute that is transformed into information stored on a computer chip or

a personal computer (PC) so that it can be transferred over information systems such as the Internet. Technology permits the transmission of electronic value over networks that link PCs and the storage of electronic cash on the hard drives of PCs.<sup>13</sup>

One type of Internet-based e-money system has been described as a token or notational system. These computer-based systems involve a customer purchasing electronic tokens that serve as cash substitutes for transactions over the Internet. With this type of system, “money” or “value” is purchased from an issuer (who may be a bank or a non-bank). The value is then stored in a digital form on a consumer’s PC and the notational value is transferred over the Internet.

The “coin” is merely a notational series of numbers or other symbols that are transmitted over the Internet to a merchant. The merchant must then redeem the “coin” with an issuer that will verify that the coin has not been spent previously. The issuer of the Internet e-money is obligated to redeem these payments when received from the merchant. Digicash was an early example of this type of system.<sup>14</sup>

In addition to token or notational systems, there are also “account-based” e-money schemes. Account-based schemes involve a consumer purchasing “e-money” by debiting an existing bank account or using a credit card to buy cyber “coins.” The value is then stored on the issuer’s records and the consumer may access the records. The merchant that accepts the e-money ultimately redeems the account-based e-money with a bank or credit card company. The defunct Cybercash was an example of a system in which customers could purchase cyber coins to make micropayments over the Internet.<sup>15</sup>

Many of the first generation e-money systems were software-based e-money schemes, which could be managed by local software installed on a user’s local computer. Such applications have apparently vanished from the marketplace.<sup>16</sup> In their place are new server-based accounts. Some server-based accounts are linked to e-mail addresses or mobile phone numbers. The other types of accounts sell prepaid funds that are linked to a personal identification number or access code.

In such systems the record of the money or value available to the consumer is lodged on a central server. Consumers can access their account information by logging on to a website or accessing the data via a wireless device.<sup>17</sup> This new type of server-based e-money has some features of the stored-value products listed below—the main distinction is that the value is dematerialized and is not linked to a physical “card.”

### **Stored Value**

During the 1990s, stored-value products were an innovation in payment systems technology. Today, stored-value products are often referred to as “prepaid” cards, referring to the fact that consumers pay value up front to purchase a card. The card is often used to pay for goods or services from a merchant or a host of merchants.

One class of stored-value products possesses certain basic characteristics. According to the U.S. Federal Reserve, stored-value products share three attributes: “(1) [a] card or other device electronically stores or provides access to a specified amount of funds selected by the holder of the device and available for making payments to others; (2) the device is the only means of routine access to the funds; and (3) the issuer does not record the funds associated with the device as an account in the name of (or credited to) the holder.”<sup>18</sup>

Stored-value cards have also been referred to as “smart” cards, or value-added cards. These cards record a balance on a computer chip that is debited at a point-of-sale terminal when a consumer or individual makes a purchase. Typically, a consumer will pay a bank or other provider money in exchange for a card that is loaded with value. The value can evidence the provider’s promise (typically to pay money) or can evidence the promise of a trustworthy third party. The consumer uses the card rather than paper currency to purchase goods and services.

Merchants who accept smart cards can typically transfer the value of accumulated credits to their bank accounts. A smart card is not typically used for transactions over the Internet, although this may be changing with the advent of new credit card products that include a stored-value component or chip. With other types of stored-value



products, the value is recorded and stored on a computer server, rather than directly on the card.

One of the earliest versions of a stored-value product was the Mondex card. Mondex was a proprietary, privately held technology designed to create and circulate e-money using smart cards. Mondex aimed to substitute smart cards for existing physical cash. Mondex was developed by the NatWest Group in 1990. The first trial using Mondex technology began in 1992 involving over 4,000 staff in NatWest's London offices paying for purchases in staff restaurants and shops. The first public trial commenced in Swindon, England in 1995, followed by subsequent trials with British universities. Mondex International was subsequently formed in July 1996. Mondex was tested in other European and North American markets including New York City. The New York City trial was deemed a failure as consumers failed to widely adopt Mondex as a preferred form of payment.<sup>19</sup>

The ownership structure of Mondex was complex. It consisted of several interdependent entities. Mondex International consisted of a consortium of international banks including Citibank and Chase, as well as Visa and MasterCard. MasterCard held a 51 percent ownership share and acquired full ownership in 2001.<sup>20</sup>

There are different types of stored-value cards. Some cards are part of so-called "closed" systems, in which a consumer can use a card for a limited range of goods or services provided typically by one merchant or one issuer. An example of a closed system would be a university photocopy card or a subway system metro/transit card. In these examples, a stored-value card can be used to purchase a narrow basket of services. At the university, a student would use a photocopy card to make copies in the library. A subway rider would use his or her card for riding on the subway and perhaps also on a city bus.

"Open" systems are systems in which a stored-value card may be used as a cash substitute. The card is widely accepted by merchants and vendors in lieu of physical cash. An example of an open system would be a stored-value or prepaid debit card, in which the consumer may use the card at a wide range of merchants to pay for a large universe of goods and services. Some commentators make a distinction between open prepaid cards that operate as debit or automated teller

machine (ATM) cards and prepaid purchasing cards that can be used widely throughout a country to purchase goods or services only, but are not redeemable as cash. Such cards are also referred to as universal gift cards.<sup>21</sup>

“Mixed” or “semi-closed” systems are ones that have features of open and closed systems. A stored-value gift card program offered by a shopping mall might be an example of a mixed system. For example, a stored-value gift card might be accepted by multiple merchants within a shopping mall. This system is not entirely closed because a wider array of merchants have agreed to accept the card as a means of payment. At the same time, the system is not “open” as the card may have no use outside the walls of the shopping center.<sup>22</sup>

These distinctions only become important as regulators attempt to determine which types of systems to regulate. The concern with any prepaid funding scheme, such as stored value, is whether the issuer, by selling consumers prepaid value, will end up holding enough of the consumers’ or other purchasers’ funds so as to pose a safety and soundness risk to purchasers.<sup>23</sup> Closed systems do not pose the same sort of risks as open ones, in which cards serve as proxies for cash. Defining the different types of stored-value cards is an area of continued regulatory analysis.<sup>24</sup>

### **Electronic Scrip**

Stored-value cards, token or notational systems, as well as account-based systems, may all involve exchange of value that is not redeemable in money. The term “scrip” has been used to refer to value that may be exchanged over the Internet but that may not be redeemable for money. Scrip is analogous to coupons or bonus points that can be exchanged by a consumer for goods or services but have no cash redemption value. Scrip can be used by merchants to sell access to value-added web pages on a per-access basis or a subscription basis. Merchants can also use scrip to provide promotional incentives to users. Scrip can represent any form of currency, points in a frequent user program, access rights, and so forth.

During the late 1990s, there were new micropayments systems being developed that allowed customers to either earn reward points online or to purchase points or “value” that is redeemable for goods and services rather than for money. One such example was Flooz, which issued its own gift “money.” Flooz issued what were essentially online gift certificates. A customer could open an account and was then able to purchase a certain amount of Flooz’s reward “dollars.” Then, the person could send the dollars to anyone with an e-mail address (along with a card). The recipient, upon receipt, opened an account and then could spend the gift “dollars” at any participating store that accepted the “dollars.” It was not apparent from the Flooz website whether its “dollars” were redeemable in cash or merely in goods and services. Flooz filed for bankruptcy in 2001.<sup>25</sup>

Another U.S. company, Beenz, offered online points that were billed as web “currency.” Beenz’s “points” were units that consumers could have earned when visiting various websites, filling out surveys, or engaging in other online activities for which merchants seek to reward consumers. The points accrued and were stored in an online “account” that a customer could access to redeem his or her “points” for various goods and services. The points were not redeemable for money, and the company stated that it could discontinue the service at any time. Beenz offered an account-based payment system that issued nonredeemable points. Beenz also closed in 2001.<sup>26</sup>

The issue of whether loyalty cards and related Internet points or scrip are subject to regulation in the United States and the European Union remains an open question for the business community.<sup>27</sup>

### **Internet Funds Transfer**

Various payment services offered by banks and nonbanks will transfer money over the Internet. Internet funds transfer replicates traditional money transmission but uses the Internet, PCs, and e-mail to initiate transactions. One such service, offered by PayPal, will transfer money over the Internet to anyone who has an e-mail address. Consumers who wish to send money via the Internet must first establish an online account with PayPal. A consumer can fund his or her account with payments from a credit card, a bank account debit, or by sending in a money order or check.

PayPal holds the consumer's money until it receives a request to transfer the funds to a recipient. A transfer is effectuated by sending an e-mail to the recipient. The recipient then has several options for receiving payment ranging from establishing his or her own online account with PayPal, having the funds transferred to an existing bank account, or, if the customer has no bank account, receiving a check from PayPal. One of the reasons for PayPal's growth and popularity is that it provided a low-cost alternative to credit cards in the online auction market. In 2002, PayPal was acquired by online auction giant eBay.<sup>28</sup>

### **Gold/Precious Metals Transfer and Payment**

Somewhat similar to an Internet funds transfer system is a system whereby customers transfer precious metal via accounts on the Internet. One company that offers this service is e-gold. With e-gold, rather than having an "account" with e-money denominated in U.S. dollars, a customer sets up an online account and buys gold, silver, platinum, or palladium. The customer then has "x" grams or troy ounces of the precious metal. One can only send money to or purchase items from an existing customer or participating merchant. Customers reportedly can utilize their precious metal accounts to buy goods and services, to receive payment from third parties, and to pay bills.<sup>29</sup>

### **Mobile Payments**

Mobile payments are the most recent type of e-money application, focused on the use of cellular phones and other mobile devices as mechanisms for transferring money or prepaying for goods and services. Mobile payments are point-of-sale payments made through a mobile device, such as a cellular telephone or a personal digital assistant (PDA).<sup>30</sup>

Using mobile payments, a consumer could purchase a plane ticket using his cell phone to authorize payment (either debiting his bank account using the cell phone as a device or debiting a prepaid account lodged with the cell phone provider or other business). If a restaurant patron wanted to pay his check quickly without waiting for the server to take his credit card, he could use a PDA to authorize payment. A

consumer could pay for soda or candy from a vending machine using a cell phone to make the purchase.<sup>31</sup>

## **U.S. Regulation of Electronic Money**

### **Prudential Framework for Nonbanks**

In the United States, bank issuers of e-money are regulated at the federal level through federal banking regulators such as the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC).<sup>32</sup> These institutions regulate bank-issued electronic money and subsidiaries of banks issuing e-money as well.<sup>33</sup> To the extent that banks are already subject to a prudential regulation, the business of issuing e-money has been encompassed by a larger preexisting regulatory framework. When various banks wanted to establish an operating subsidiary to bring Mondex into the U.S. market, for example, the banks sought the approval of the OCC.<sup>34</sup>

At the same time, federal regulators have been slow to impose additional regulations on nonbank e-money issuers in the areas of consumer protection.<sup>35</sup> The recent growth of stored-value and prepaid cards has caused the Federal Reserve and the FDIC to reexamine the absence of specific federal regulation of these emerging payment methods.<sup>36</sup>

Many of the recent e-money and e-payments developments in the United States, however, have occurred among nonbanks. PayPal, which offers Internet-based funds transfer, is perhaps the most widely known.<sup>37</sup> In the prepaid market, the Starbucks card has been credited with the resurgence of prepaid or stored-value products in the twenty-first century.<sup>38</sup>

Some European commentators have noted that nonbank e-money and stored-value issuers have not been regulated within the United States.<sup>39</sup> This view has often been formed because commentators have focused more on the federal level, where there has been an absence of prudential regulation as well as consumer protection measures for e-money.

The seeming lack of federal regulation, however, relates to the fact that there is no primary federal agency in the United States charged with supervision of nonbank providers of financial services, including nonbank e-money issuers. Prudential regulation in certain parts of the nonbank sector has been left to state banking regulators, who have the authority to license and regulate these industries. Many of the issuers of e-money in the United States are nonbank entities, such as PayPal. These nonbank entities are regulated typically by state banking regulators. Federal regulators deal with nonbank financial institutions primarily with respect to anti-money laundering compliance matters.<sup>40</sup>

In the United States, the regulation of nonbank issuers of stored-value products and e-money has been an outgrowth of existing regulatory frameworks rather than a new legislative phenomenon. State regulators have made revisions to the long-standing prudential frameworks in the nonbank financial sector.<sup>41</sup> Rather than inventing something new, state regulators already had an existing model of “light-touch” safety and soundness regulation, which could be extended and applied to e-money.

For some time, a majority of the 50 states have had in place regulatory statutes for nonbank providers of “money services.” These laws provide safety and soundness protections for consumers through prudential regulation and licensing of money services providers. It is within this legislative framework that nonbank issuers of stored-value products and electronic money have been placed.

Money services businesses (MSBs) are nonbank entities that neither accept deposits like traditional banks nor make commercial loans. Rather, they provide alternative mechanisms for persons to make payments or to obtain currency or cash in exchange for payment instruments. MSBs engage in the following types of financial activities: money transmission (e.g., wire transfers); the sale of payment instruments (e.g., money orders, traveler’s checks, and stored-value cards); check cashing; and foreign currency exchange. The so-called “core” customers of MSBs are “unbanked” consumers or persons that do not maintain formal relationships with banks/depository institutions. State licensing, regulation, and oversight of MSBs vary greatly.<sup>42</sup>

Nonbank issuers of e-money and providers of certain types of electronic payments have been grouped together with MSBs. As early as 1997, the U.S. Department of Treasury, via its Financial Crimes Enforcement Network (FinCEN), coupled these disparate industries together, as entities that sold payment instruments or transferred funds for consumers, but did not accept deposits or make loans. Along with the traditional brick-and-mortar money services, FinCEN also grouped stored-value products under the same umbrella.<sup>43</sup>

Direct oversight of MSBs occurs at the state level through state licensing laws. The sale of payment instruments and money transmission is the most regulated activity with more than 45 states having some form of law that regulates the sale of checks and other payment instruments and/or money transmission.<sup>44</sup> States vary in the extent to which they regulate both payment instrument sellers and money transmission—with some states regulating money transmission, others the sale of payment instruments, and still others a combination of the two activities.<sup>45</sup>

The existing state MSB laws vary in terms of detail and the requirements imposed on MSBs, the type of enforcement mechanisms and records available to regulators, and the nature of penalties for noncompliance with relevant state laws. The Money Transmitters Regulators Association (MTRA),<sup>46</sup> an association of state regulators that deal with certain aspects of money services, has a model legislation outline that lists some of the core elements of a state licensing law. Some of the common elements of existing state law include

- licensing and registration of MSBs (with more detailed requirements for payment instrument sellers and money transmitters than for check cashers or currency exchangers);
- bonding, collateral, and net worth requirements;
- examination of MSBs;
- record keeping requirements;
- regulatory reporting requirements;
- permissible investment requirements (limiting MSB investment of funds held for customers in safe and highly liquid investments);

- enforcement powers; and
- civil and/or criminal penalties.

In the late 1990s, several American states took the position that the transfer of money over the Internet or the use of an electronic payment instrument was the equivalent of money transmission in the brick-and-mortar world. Internet payment services were treated as the equivalent of money services because (1) the business entities constituted nondepository providers of financial services and (2) they accepted customer funds for transmission to third parties. Such Internet payment mechanisms include online bill payment services and Internet funds transfer services as well as stored-value and e-money issuers (which can be used online or offline). Several states also included stored-value products within their existing money transmission laws.<sup>47</sup>

In addition to the efforts of individual states, a new uniform law was promulgated that provided a recommended uniform framework for the licensing and regulation of MSBs throughout the 50 states. On August 3, 2000, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Money Services Act (UMSA).<sup>48</sup>

The UMSA is a state safety and soundness law that connects all types of MSBs and creates licensing provisions for them. Among the goals of the uniform act was the suppression of money laundering by requiring MSBs to register with state regulators and adhere to safety and soundness requirements. The UMSA also placed the various forms of stored-value products and e-money emerging in the Internet economy under one law.

As noted above, state MSB regulation is a lighter form of prudential regulation. Since MSBs are not banks, they do not pose the same type of systemic risks that depository financial institutions may pose. As such, while there are certain regulatory constraints placed on MSBs, they are not as detailed or as extensive as the regulation that exists for depository institutions.



In 1994, the U.S. Congress enacted the Money Laundering Suppression Act (MLSA). The MLSA urged states to enact uniform laws to “license and regulate” MSBs including “businesses which provide check cashing, currency exchange or money transmitting or remittance services, or issue or redeem money orders, traveler’s checks and other similar instruments.” Congress specifically requested that the states develop uniform legislation under the auspices of either NCCUSL or the American Law Institute.<sup>49</sup>

NCCUSL responded to the congressional request. In 1997, a Drafting Committee was established to prepare a uniform licensing statute for money services. In October 1999, NCCUSL commissioned a Cyberpayments Working Group to examine the issue of whether stored-value, e-money, and other Internet payment mechanisms should be included within the scope of the UMSA.

In March 2000, the Drafting Committee considered the recommendations of the Cyberpayments Working Group and decided that Internet-based payment mechanisms should be included within the scope of the UMSA to the extent that such services involved the sale and issuance of monetary value or the transmission of monetary value by a nonbank, if the nonbank also holds a consumer’s money for its own account prior to redemption.

It was the holding of consumer funds that triggered concerns about safety and soundness. One of the primary tests as to whether an emerging electronic payment mechanism should be regulated relates to this issue of whether the business entity “holds” the consumer’s funds for any period of time, giving rise to a possible loss to the consumer if the issuer fails or absconds.

Ultimately, the UMSA did not include new or different licensing regimes for Internet payment mechanisms; rather it applies the existing licensing frameworks to new technologies.<sup>50</sup> A nonbank entity that provides Internet funds transfer, such as PayPal, for example, would be treated the same as a company like Western Union that provides traditional nonbank funds transmission services. In the comments to the UMSA, nonbank Internet funds transfer was described as an activity that would fall within the scope of the Act. PayPal, when it accepts money from customers, which will be ultimately transmitted

to third party recipients, is holding funds for consumers, thus raising safety and soundness concerns.

The UMSA Drafting Committee made the following decisions with respect to e-money:

- The UMSA expanded the definition of “money” to reflect the fact that certain payment service providers employ a form of value that is not directly redeemable in money, but nevertheless (1) serves as a medium of exchange and (2) places the customer at risk of the provider’s insolvency while the medium is outstanding. The same safety and soundness issues pertinent to redeemable forms of value apply to these irredeemable forms of value.
- Monetary value is defined as “a medium of exchange, whether or not redeemable in money.” The term “medium of exchange” connotes that the value that is being exchanged be accepted by a community larger than the two parties to the exchange. Hence, bilateral units of account, such as university payment cards, would not constitute “monetary value” for purposes of this Act. The definition of monetary value remains flexible to allow regulators to deal with emerging forms of monetary value and Internet scrip on a case-by-case basis. The term “monetary value” is defined so as to exclude pure barter or activities where the value that is being exchanged is used for exchange with a single issuer or merchant or within a small geographic radius.
- Under the UMSA (as with existing state money transmission statutes), state regulators will also have to make the same type of determination as to when a certain type of monetary value has become so widely accepted that it constitutes a medium of exchange.
- In the UMSA, the definition of stored value removes the requirement that value be stored on an instrument, because the instrument in which the stored value is embedded is not conceptually relevant.
- Because monetary value is defined as “a medium of exchange, whether or not redeemable in money,” only stored value that consists of a medium of exchange evidenced in electronic record would qualify as stored value for purposes of regulation. A me-

dium of exchange needs to be something that is widely accepted. Closed systems, as mere bilateral units of account, therefore would be excluded from regulation.

- Internet payment services that hold a customer's funds or monetary value for their own account rather than serve simply as clearing agents also fall within the definition of money transmission. By contrast, entities that simply transfer money between parties as clearing agents should clearly fall outside the scope of a safety and soundness statute. Similarly, the definition excludes entities that solely provide delivery services (e.g., courier or package delivery services) and entities that act as mere conduits for the transmission of data, such as Internet service providers.

The final comments to the UMSA were promulgated in May 2001. Vermont was the first state to adopt the Act in April 2001. Several other states have followed suit, including Iowa, Texas, and Washington, along with the U.S. Virgin Islands.<sup>51</sup> While the UMSA has not been adopted as widely as anticipated, it serves as a useful reference template for understanding prudential regulation of e-money in the United States. Many states that have amended their existing money services laws to encompass e-money and stored-value products have been influenced by the UMSA's definition of monetary value.<sup>52</sup>

The UMSA is meant to exempt small, closed stored-value systems from regulation. As the official commentary to the UMSA notes, when explaining the concept of "monetary value":

The term "monetary value" is defined in such a manner as to exclude pure barter or activities where the "value" that is being exchanged is used for exchange with a single issuer or merchant or within a small geographic radius. Of course, regulators will have discretion with respect to which entities are engaged in the transmission or issuance of monetary value. Some States, such as Texas, for example, require the issuer of mall gift certificates that can be redeemed at multiple issuers to become licensed.

With Internet payments, the regulators will also have to make the same type of determination as to when a certain type of monetary value has become widely accepted as to

constitute a medium of exchange. For Internet payment systems that involve Internet scrip or points (e.g., frequent flier or bonus points), regulators will need to grapple with how widely circulating such points are, whether they are redeemable, and whether they can be used to purchase or acquire a wide range of products and services. Certain types of bonus points are now donated to charities, for example, which can then sell them or auction them to individuals for a profit. The wider the use and the greater the circulation of a certain type of value, the more it replicates a medium of exchange.<sup>53</sup>

### **Has the U.S. Regime Fostered Innovation in the U.S. Market?**

The UMSA and other state money transmission laws have had an impact on e-money issuers. A company such as PayPal must now be licensed as a money transmitter in many of the states in which it does business. As a “money transmitter” (similar to Western Union), PayPal must now subject itself to licensing and bonding in multiple states.<sup>54</sup> It must also invest its funds in permissible investments and comply with other components of the state licensing laws.<sup>55</sup>

While a large market participant such as PayPal will capture a regulator’s attention, many other emerging entrants may be unaware that their business model requires them to obtain a money transmission license in a given state. One reason for this is that the lawyers who advise e-payments providers have tended to be lawyers who represent clients in the high-technology sector rather than attorneys who represent banks or MSBs. Such lawyers may be unaware of MSB regulation. In addition, it is unclear whether state regulators have the financial resources or capacity to enforce existing state laws against e-money issuers.<sup>56</sup> In this sense, ignorance of the law, and lack of enforcement, suggests that e-money regulation in the United States has not hindered innovation. At the same time, the United States has not emerged as a front-runner in the e-money arena.

At present, it is difficult to assess the impact of money services regulation on the development of e-money and other e-payments schemes. With the rise of nonbank schemes, there has also been an emerging growth in consumer use of debit cards and automated clearinghouse systems to make payments. Thus, while e-payments are

growing, e-money is one of a larger array of options available to the American consumer.<sup>57</sup>

The U.S. legal framework as applied to nonbank providers of e-money is certainly “light-touch” regulation. The attractiveness of the U.S. legal regime is that a company that operates as an e-money issuer or Internet funds transfer service does not need to have a large amount of capital in order to start a business. There are typically no initial capital requirements for MSBs. The few states that impose a “net worth” requirement for entry into the market set the dollar amounts at relatively low levels (e.g., US\$25,000 or under).

While the lack of minimum capital requirements may seem surprising at first, one should remember that the state prudential frameworks for money services entities have been in place for quite some time. They have been applied to brick-and-mortar entities such as Western Union and other companies and have not given rise to widespread systemic failure in the MSB industry.

Consumer funds are nonetheless protected under a more light-touch system of prudential regulation because a licensed MSB must invest its customers’ money (while an obligation remains unredeemed or outstanding) only in so-called safe, permissible investments that are low risk and highly liquid. MSB licensees are also subject to regular inspection by state banking regulators and must purchase a security bond to protect consumers in the event of default or insolvency. Regulators also have enforcement authority and the ability to routinely examine their nonbank licensees.

One of the possible major impediments in the United States to the wider use of e-money is the fact that issuers of e-money or providers of Internet payments must be licensed in multiple states—thus incurring duplicate and at times redundant obligations. There is currently no widespread system for creating reciprocal licensing or a multistate “passport” regime for licensed e-money issuers. In 2004, NCCUSL adopted proposed amendments to UMSA to provide for a reciprocal MSB licensing regime.<sup>58</sup> To date, the amendments have not been adopted by any of the states.

There is, moreover, no uniform standard applied by the 50 states when it comes to the regulation of e-money issuers. Critics often refer to the patchwork of regulations that exists in the United States, making it difficult for businesses to comply in an efficient manner. MTRA as the regulatory body has moved to create uniform reporting forms and to encourage joint supervisory examinations as a way of creating efficient and cost-effective solutions of multistate licensees.<sup>59</sup>

Industry participants are also critical of state regulatory approaches (particularly in the area of stored value), because the definitions leave room for regulatory discretion and interpretation (e.g., UMSA requires that stored-value issuers be licensed and regulated when the stored value becomes equivalent to a “medium of exchange”). Critics of this approach note that this does not give prospective e-money issuers guidance as to whether a particular quasi-closed or mixed system would fall within a particular state’s licensing laws.

### **Electronic Money Regulation in the European Union**

As in the United States, European nonbanks have developed e-money products.<sup>60</sup> Commercial banks responded to this phenomenon with e-money products of their own such as Proton in Belgium, the Chipknip in the Netherlands, and Quick in Austria.<sup>61</sup> As with the United States, e-money schemes have been slow to be adopted.<sup>62</sup>

The European Monetary Institute<sup>63</sup> issued an initial report in 1994, which analyzed the consequences of the first wave of e-money products. The “Report to the Council of the European Monetary Institute on Prepaid Cards” stated that entities that issued prepaid multi-purpose cards could be characterized as taking deposits from the public.<sup>64</sup> Consequently, the European Monetary Institute recommended that issuers be regulated under existing banking supervision laws.<sup>65</sup>

During the latter part of the 1990s, central banks and banking regulators further examined the possible risks associated with e-money in relation to monetary policy and prudential supervision. As the Association of Electronic Money Issuers in the Netherlands recently pointed out:

The main position of central banks and supervisors in Europe is best illustrated by the statement, in a lecture for the IBIT Forum in Basle on June 11, 1996, by Wendelin Hartmann, a member of the Directorate of the Deutsche Bundesbank: “Consequently, the EU central banks have agreed as an initial step to ensure, above all, that this development is subject to control. In all EU countries, therefore, legal initiatives have been set in motion, as a result of which only credit institutions which are subject to banking supervision will be allowed in future to issue multi-purpose prepaid cards.”<sup>66</sup>

The European Commission proposed an initial draft directive on electronic money institutions in 1998. This proposal was meant to facilitate the development of innovation and to encourage new market entrants such as nonbanks into the e-money sector.<sup>67</sup> The European Central Bank responded and requested changes to the proposed directive.

The final version of the Directive was published in the *Official Journal of the European Communities* on October 27, 2000. The European Commission emphasized competition and innovation as one of its primary goals for introducing the E-Money Directive.<sup>68</sup> The E-Money Directive introduced a new type of institution, distinct from the “credit” institution (bank) that would be subject to lighter-touch regulation. Member states were required to implement the Directive by April 27, 2002.

The E-Money Directive has several goals. These include (1) harmonizing the member states’ laws, (2) ensuring consumer confidence by supervision of electronic money institutions, and (3) fostering competition in the sector of electronic money. At the core of the E-Money Directive stands its definition of “electronic money.”<sup>69</sup> The E-Money Directive sets forth a new supervisory regime for companies whose sole purpose is to issue electronic money. This dedicated legal regime is a trimmed-down supervisory regime based on the traditional prudential framework for credit institutions.<sup>70</sup>

According to the preamble of the Directive, there are several main objectives for the enactment of the Directive: (1) to assist electronic money in delivering its “full potential benefits” and avoid “hampering

technological innovation” (Recital 5), (2) to “ensure bearer confidence” (Recitals 4 and 9), and (3) to “preserve a level playing field between electronic money institutions and other credit institutions issuing electronic money” (Recital 12).

Electronic money is defined within the Directive in a way that resembles the definition in UMSA. It also adopts a concept of “monetary value.” Article 1 of the E-money Directive<sup>71</sup> defines “electronic money” as

Monetary value as represented by a claim on the issuer which is:

- (i) stored on an electronic device;
- (ii) issued on receipt of funds of an amount not less in value than the monetary value issued; and
- (iii) accepted as means of payment by undertakings other than the issuer.

The criterion in (iii) is meant to distinguish electronic money from sole-purpose stored-value products (closed systems) where the issuer sells a consumer value that may be redeemed solely for a narrow class of good or services offered by the issuer. Phone cards or photocopy cards are examples of such systems.<sup>72</sup>

Article 2(3) of the Directive also notes that an issuer’s receipt of funds from a customer will not constitute a “deposit” within the meaning of Article 3 of the EC Directive on Credit Institutions “if the funds are immediately exchanged for electronic money.”<sup>73</sup> This is a critical provision, as deposit taking in the European Union requires businesses to adhere to stricter prudential requirements. At the same time, some commentators have noted that the term “immediately exchanged” is vague and requires more clarity.<sup>74</sup>

The E-Money Directive creates a two-tier regulatory regime. In addition to traditional credit institutions (e.g., banks), the Directive creates a new institution referred to as an electronic money institution (EMI). EMIs are subject to a less restrictive prudential regulatory regime. This is meant, in part, to foster competition in the e-money sector and to allow nonbanks to participate in the marketplace. Such an institution should

- possess initial capital of an amount of at least €1 million;



- invest all funds received by customers in liquid assets;
- solely perform business activities that are closely related to issuing e-money;
- ensure sound and prudent management;
- redeem electronic money at “par value” upon request of the consumer; and
- comply with certain know-your-customer and suspicious transactions reporting requirements.

Other main features of the EMI Directive include the following:

- **A Single Passport Principle.** Under the so-called “country of origin principle” (sometimes referred to as a “single passport”), an EMI properly licensed in one member state may conduct business in other member states with a single license.
- **Waivers.** member states may waive the application of the EMI and the Banking Directives to EMIs if the overall e-money scheme is limited in scope.

Since it is easier to become an EMI than a full-fledged credit institution, it was anticipated that the Directive would lower the entry costs and impediments for nonbanks. Similarly, it was expected that the single passport would make it easier for nonbanks to offer a European product rather than national e-money products. This, in turn, would facilitate a stronger internal market, reinforced by common European payment schemes.

The Directive’s waiver requirement was meant to allow small limited purpose schemes to be exempt from regulation as EMIs. This would allow local, community-based e-money schemes to flourish alongside larger pan-European ones. Article 8 of the E-Money Directive allows member states to waive the application of some or all of these provisions to electronic money institutions, provided that a proposed electronic device has a maximum storage capacity of €150 and meets one of the following criteria:

- total business activities of the issuer do not normally exceed €5 million and never exceed €6 million;
- the e-money issued is accepted only by the issuer's subsidiaries, by the issuer's parent undertaking, or by any subsidiaries of that parent undertaking; or
- the e-money issued is accepted only by a limited number of undertakings (which are within a limited local area, or in a close financial and business relationship with the issuer).

Smaller schemes, while exempt from licensing and supervision, may not operate in other member states without either seeking an independent waiver from other European regulators or obtaining a license (i.e., by operating across multiple borders, the EMI may, by definition, be engaged in business that should be supervised).

### **Implementation of the E-Money Directive**

As of 2002, only 10 of the 15 European member states had met the timeline for the implementation of the E-Money Directive.<sup>75</sup> There is also considerable local variation in how the Directive was implemented. For example, the definitions of e-money adopted by the various member states differed considerably. As one report notes:

Austria and Ireland have specified the maximum amount of e-money to be stored on an electronic device (2,000 and 5,000 euros, respectively)...

In Spain and Austria, specific clauses have been formulated in the law itself to confirm that funds received from the public do not constitute a deposit if these funds are exchanged for e-money. In the Netherlands, e-money is more broadly defined as "monetary value on an electronic device." In Sweden, e-money is defined as "a monetary value representing a claim on the issuer and which, without existing in a individualised account, is stored in an electronic medium and approved as a means of payment by others than the issuer."<sup>76</sup>

As in the United States the types of e-money systems that are regulated and that are exempt is still ambiguous. The Article 8 waiver process, for example, is creating significant differences in who is or is

not licensed in different member states. In some member states no waivers have been introduced.<sup>77</sup>

In the United Kingdom, implementation of the Directive's Article 8 waiver provisions provided additional criteria beyond those set forth in the Directive itself with respect to what constitutes a local e-money scheme or "area." In the United Kingdom, the Financial Services Authority allows so-called "small issuers" to apply for a certificate that expressly excludes their business activities from being regulated.<sup>78</sup> A certificate will be granted if "the e-money issued is only accepted by not more than one hundred persons (and these persons are within the same premises or in a limited local area—a shopping center, an airport, a railway station, a university campus; or any area that does not exceed four square kilometers—or where the persons are in a close financial and business relationship with the issuer)."<sup>79</sup> Critics of the British waiver provisions note that these geographic and population restrictions are arbitrary and problematic to apply in practice.

### **Does the E-Money Directive Provide Incentives for Innovation?**

At present, many stakeholders within the European Union are examining the issue of whether the E-Money Directive helps or hinders e-payments innovation. The European Commission recently launched a consultation to examine the impact of the directive on the market. In a recent consultation document the Commission services (DG Internal Market) noted the following:

The Commission services' impression at the start of this review process [...] is that the original ambitions of the Directive (improve the single market for financial services, create legal certainty, encourage new market entrants, contribute to the development of E-commerce) have not been achieved, or at most only partly—and indeed that far from improving the single market for E-money institutions and encouraging new entrants, the Directive may have had the unintended effect of constraining the development of the market.<sup>80</sup>

As evidence of the constraining effect of the Directive, the Commission notes that few e-money licenses have been authorized and that many supervisory authorities have waived certain provisions of the Directive as permitted by Article 8.

Some of the same concerns are echoed at the member state level. Critics of the E-Money Directive have noted that the final version of the E-Money Directive was restrictive and did not provide incentives for nonbanks to form EMIs.<sup>81</sup> Some member states view implementation of the Directive at the local level as noncoherent. As a result, there is a perception that competition is not level among member states.<sup>82</sup>

The scope of the Directive is also viewed as unclear in several respects. It is unclear, for example, whether the Directive applies to certain types of new products such as loyalty or bonus-point schemes like the scrip-type programs outlined above.<sup>83</sup> As one commentator queries,

If the Directive covers bonus-point or barter schemes, they would have to adhere to the redeemability requirement. Up until now, many of these schemes have issued nonredeemable value points. Thus, if the Directive covers bonus points, the question arises whether it is really necessary to force redeemability on such schemes.<sup>84</sup>

Regulators in some EU member states are also struggling to understand the complexities of the e-money market and the new technologies being used to facilitate e-payments. In Germany, for example, banking regulators may be classifying PayPal-type payment schemes as deposit-taking activities. The European Commission held a consultation on the application of the E-Money Directive to mobile payment operators, because different member states had taken contrary views on the subject.<sup>85</sup>

As for specific impediments, the initial capital requirement of €1 million may be the most significant deterrent to the growth of EMIs. Such a capital requirement may favor incumbent market participants rather than new entrants. For example, banks and telecommunications companies are the type of incumbent market players that have the type of capital that would permit the formation of a stand-alone e-

money business. As one commentator notes, “what is missing is a growth path for small issuers that want to go transnational and a framework that provides financial incentives for ‘start-ups’ to launch new, Union-wide payments products. The Directive would hence appear to fail in its first objective, which is ‘to assist electronic money in delivering its full potential benefits.’”<sup>86</sup>

### **The EMI Directive and the UMSA Compared**

The UMSA and the E-Money Directive were drafted in two different regulatory jurisdictions—each done in isolation and without the benefit of the other jurisdiction’s work.<sup>87</sup> The UMSA was drafted by a quasi-legislative nongovernmental body representing lawyers from the 50 states. The UMSA may represent a more bottom-up approach to the regulatory issues. In the United States, nonbank e-money issuers were folded into an existing light-touch prudential framework. Experts at a supranational level, in contrast, drafted the E-Money Directive.<sup>88</sup> In Europe, a new framework was created exclusively for e-money issuers, derived in part from existing regulation of credit institutions.

Despite the differences in drafting approaches, there are striking similarities between the two legal frameworks. This suggests that while further refinements may be needed, both the UMSA and the E-Money Directive represent useful first steps in the prudential regulation of e-money.

The main objectives of the UMSA are also similar to those found in the preamble to the E-Money Directive: (1) providing a harmonized and uniform legal framework with respect to MSBs, (2) ensuring the safety and soundness of MSBs, and (3) reducing barriers to competition and growth in new sectors such as emerging Internet and electronic payment mechanisms.<sup>89</sup>

The UMSA’s definition of “stored value” also resembles the Directive’s concept of “electronic money.” “Stored value” is defined as monetary value that is evidenced by an electronic record (i.e., “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form”). As noted earlier, in the European Union, electronic money is defined by the E-Money Directive as “monetary value as represented by a

claim on the issuer which is: (1) stored on an electronic device; (2) issued on receipt of funds of an amount not less in value than the monetary value issued; and (3) accepted as means of payment by undertakings other than the issuer.”<sup>90</sup>

The UMSA’s inclusion of value that is nonredeemable obviously differs from the EMI Directive’s requirement of redeemability but the notion of monetary value that may be stored electronically is an essential concept underpinning both legal regimes. The rationale for the extension of the UMSA to encompass transactions involving monetary value is as follows: “certain payment service providers employ a form of value that is not directly redeemable in money, but nevertheless (1) serves as a medium of exchange and (2) places the customer at risk of the provider’s insolvency while the medium is outstanding. The same safety and soundness issues pertinent to redeemable forms of value apply to these irredeemable forms of value.”<sup>91</sup>

The concept of “medium of exchange” is further defined as the value that must be accepted by parties other than the issuer (open systems).<sup>92</sup> This corresponds with Art. 1(3)(b)(iii) of the EMI Directive, which also excludes closed systems. The flexibility that is inherent in the UMSA’s definition (“[w]ith Internet payments, the regulators will ... have to make the determination as to when a certain type of monetary value has become widely accepted as to constitute a medium of exchange”) is perhaps analogous to the Directive’s waiver provision for limited undertakings in Art. 8(1)(c).<sup>93</sup>

EMIs and MSBs are also subject to the following shared regulatory requirements:

- licensing and approval requirements (UMSA § 201—License required; and E-Money Directive Article 1—Scope, Definitions, and Restrictions);
- a prudential supervisory regime (UMSA § 203—Security; § 206—Net Worth; and §§ 601 *et seq.* Examinations, Reports, Records; and E-Money Directive Articles 4—Initial Capital; 6—Verification; and 7—Sound and Prudent Operation); and
- restrictions on permissible investments to safeguard funds received from consumers while the e-money or stored value is outstanding and to guarantee safety and soundness (UMSA § 701 *et*

*seq.*; and E-Money Directive Article 5—Limitations in Investments).<sup>94</sup>

There are many similarities between the UMSA and the E-Money Directive in terms of core definitional concepts relating the obligations imposed upon nonbanks that issue e-money. There are, however, a few key distinctions between the UMSA and the E-Money Directive. First, the E-Money Directive requires an EMI to have a minimum initial capital of €1 million. By contrast, the UMSA and other state money services statutes require either no net worth or a minimum amount of US\$25,000 or less.

The UMSA *does* require licensees to obtain what is referred to as a surety bond (against which consumers can claim in the event of certain triggering events including insolvency).<sup>95</sup> This bond, however, is a form of insurance and costs much less to purchase. In some states, the regulator can waive the bond requirement or a substitute security instrument (e.g., a letter of credit) can be used in place of the bond. Thus, the financial cost of starting a nonbank e-money enterprise in the European Union appears, upon an examination of the laws on the books, to be significantly higher than in the United States. It is important to note, however, that EU capital requirements may be waived for smaller EMIs under Art. 8 of the Directive.

When first enacted, the UMSA lacked any sort of passport principle. This meant that U.S. nonbank e-money issuers would have to obtain licenses in each jurisdiction in which they conducted business (usually defined by regulators as when there are customers located in a given state). This was a sharp contrast with the E-Money Directive, which allowed an EMI to obtain licensing or approval in one EU member state as a basis for operating throughout the EU market. It also is a disadvantage for nonbanks who have to compete with banks that can take advantage of national charters or reciprocal interstate branching.

As noted above, NCCUSL amended the UMSA in 2004 to permit a licensee to operate in other states with its original license if the states both have substantially similar regulatory regimes. In practice, however, there still exists a lack of passporting in the United States. Because only a few states have adopted the UMSA (and, as of now, without the recent amendments), companies such as PayPal must ob-

tain multiple licenses and secure multiple security bonds for the states in which they do business. MSBs in the United States (and MSBs from abroad offering services in the United States), provided there is a sufficient jurisdictional nexus (which will more often be the case than not in the context of electronic commerce), must obtain licenses in states where their customers reside. As one commentator noted, “It may come as a surprise for many Europeans that conducting interstate business within the U.S.A. may be much more cumbersome than conducting international business within the EU.”<sup>96</sup> That being said, the fact that many regulators have not moved to actively regulate e-money and stored-value products means that few issuers have encountered situations in which they are burdened by multiple licensing regimes. Traditional money transmitters, such as Western Union, have complied with this patchwork system of state prudential regulation for quite some time. Thus, it is unclear to what extent the perceived obstacle of different state laws in the United States has hindered innovation in e-money and e-payments.

### Conclusions

Current statistics regarding the use of e-money and new forms of e-payments continue to fall below expectations in the United States and in the European Union.<sup>97</sup> At present, there has been little comparative analysis of e-money regulation and its impact on the development of competing payment markets.<sup>98</sup> Thus, an inquiry into the role of laws and regulation in promoting or hampering e-money adoption is at best a tentative inquiry at present.

A brief, preliminary analysis of the EU and U.S. written legal frameworks provides a starting point for such an analysis. From an examination of written legislation, a few important and preliminary lessons emerge. First, two important economic regions of the world have developed quite similar prudential regimes to govern the non-bank sector’s involvement with e-money. While there may be individual aspects of the E-Money Directive and the UMSA that differ, certain shared core concepts of licensing and supervision are a useful baseline for prudential regulation (e.g., permissible investment restrictions is a shared approach to protecting consumer funds in both regions).



At the same time, similar criticisms have been leveled in both the United States and the European Union surrounding the scope of existing prudential laws. The business community would like more guidance on what types of emerging electronic payment methods, and existing ones, fall within the scope of either regulatory regime. Loyalty schemes and mobile payments are two examples of payment systems where the answer is unclear or may vary. In the United States, for example, different states have taken varying positions on “mixed” systems.

As for protection of “bearers,” or holders of e-money, the use of security bonds under the UMSA may be a more straightforward and lower-cost mechanism for safeguarding consumers than the capital requirements imposed by the E-Money Directive.

The fundamental question remains, however, as to what extent the current legal frameworks are a disincentive or obstacle to growth of e-money. In the European Union and in the United States, more empirical work remains to be done. The European Commission’s consultation and review of the E-Money Directive will be one of the first systematic reviews of the relationship between the Directive and the low rate of licensing of new EMIs.

In the United States, one might perceive multiple state licensing regimes to be obstacles to the entrance of nonbanks into the e-money marketplace. As noted previously, however, preliminary (and unscientific) surveys of regulators indicate that existing laws relating to money services have not been enforced or implemented in most states to create practical obstacles.

There are several competing theories as to why the uptake of e-money and other electronic payments methods have been slow. While the research is contradictory, it points to factors other than the current legal environment as significant determinants of the slow growth of nonbank e-payment schemes. Current research identifies the reluctance of consumers and merchants as larger conceptual reasons as to why the e-money has not become quickly adopted in both regions.

Some economists postulate that consumers are in fact rational decision makers. The lack of uptake of stored-value or e-money products in the United States, for example, may be because

consumers already have access to convenient credit card and debit card systems. The payments infrastructure in the United States already supports these applications.<sup>99</sup> By contrast, smart card usage is higher in Europe. This may be because the telecommunications infrastructure in Europe is slower and consumers may have greater ease of transaction with stored-value cards that do not require network authorization.<sup>100</sup>

Recent EU studies show that merchants need additional incentives in order to accept new forms of e-payments. Consumer interest is similarly a significant factor in the European Union.<sup>101</sup> In both markets, existing payment choices may be better for a variety of reasons, including the fact that certain consumer protections and error resolution mechanisms already exist for credit and debit cards, but do not exist for e-money or stored-value applications.<sup>102</sup>

There is some preliminary evidence that the type of e-money schemes that are enjoying success are limited purpose stored-value schemes.<sup>103</sup> Part of this may be because “closed” systems or small-scale e-money schemes are exempt from regulation in the United States and in Europe. Another reason for the success of stored-value cards in the more “niche” areas such as parking, public transit, and other low-value/high-speed transactions may relate to the convenience associated with stored-value products. In those contexts a merchant or service provider may prefer stored-value over credit cards, which have a higher fee per transaction.<sup>104</sup>

Another hypothesis is that payment systems that will have the most success are those that leverage existing networks and infrastructures. PayPal, for example, leverages the existing infrastructure of banks, automated clearinghouse systems, and the credit card industry to deliver Internet-based fund transfers. Similarly, new types of mobile payments may be successful because such systems leverage existing payment networks. A consumer may authorize a payment via cell phone. The payment will then be charged to the consumer’s existing bank account or cell phone bill. Thus, mobile payments leverage two existing and large networks—those of banks and of telecommunications providers.<sup>105</sup>

The other factor that has only been examined in a cursory fashion is the so-called “payment culture.” This is an amorphous term that tries to bundle together the cultural preferences and historical development of payment options in different societies.<sup>106</sup> U.S. consumers, for example, use more checks than in Europe. A research study at the Federal Reserve in Cleveland indicated that U.S. consumers like cash and thus have been slow to move to electronic money substitutes.<sup>107</sup> Some economists note that consumers are reluctant to adopt new payment methods. Some of the reluctance relates to risk of loss such as fraud risk and also credit risk, which in turn could be described as payment culture (e.g., U.S. consumers expect payment systems to offer the same fraud and error protection as credit cards).<sup>108</sup>

The empirical and qualitative research to date presents many interesting views as to why end users have not widely embraced e-money and stored-value products as predominant forms of retail payments. While this research is interesting, it asks questions that presuppose the existence of suppliers in the marketplace that are offering services to the consumer that the consumer chooses not to adopt. The questions asked in many of the recent studies about the lack of e-money penetration do not focus on a more fundamental question: is regulation hindering the creation of supply and of new e-money models that might be better tailored to consumer demand?

While further analysis of the legal environment is needed, one pattern has emerged in the United States and the European Union that should cause us to rethink the current nature of prudential regulation.

The rise and success of limited purpose, niche, or closed stored-value systems indicate that consumers and merchants see benefits in using e-money in situations where credit cards and debit cards may cost too much or not work as well in certain locations (e.g., parking kiosks or places where no human agent is present). These products typically fall outside the scope of prudential regulation under the UMSA, MSB laws, or the E-Money Directive.

Thus, one useful line of inquiry is whether the more rapid uptake of small-value schemes is because this is a less regulated payment system. Issuers may, for example, choose to go into such lines of business because there are limited regulatory burdens associated with selling coffee cards. It is also possible that the popularity or demand

for such products relates more to the narrowly tailored features of such stored-value products, which make them better alternatives to traditional payment instruments in certain circumstances. Whether regulation has influenced the success of the prepaid market merits further study.

## Notes

<sup>1</sup> James Gleick, “Dead as a Dollar,” *The New York Times Magazine* (June 16, 1996), at 9–16.

<sup>2</sup> In March 2004, the Committee on Payment and Settlement Systems of the Bank for International Settlements (BIS) published its most recent *Survey of Developments in Electronic Money and Internet and Mobile Payments*. The survey included data from 95 countries and included figures from the end of 2002 or 2003. The BIS reports: “In a number of card-based [e-money] schemes, the number of cards issued and the number of merchant terminals available for e-money transactions are considerable. However, the outstanding e-money balances (float), as well as the volume of transactions, remain small in most cases. Similarly, the value of daily transactions is low on account of the low levels of usage but also because the average value of the transactions is very small, typically a few U.S. dollars. The limited data available on float, volume and value of daily transactions, in respect to network based e-money schemes, suggest that these are very low.” Bank for International Settlements, Committee on Payment and Settlement Systems, *Survey of Developments in Electronic Money and Internet and Mobile Payments*, Report No. 62, at 3 (2004), ISBN 92-9197-667-9, <http://www.bis.org/publ/cps62.pdf>.

<sup>3</sup> Benjamin Geva and Muharem Kianieff, “Reimagining E-Money: Its Conceptual Unity with Other Retail Payment Systems,” in *Current Developments in Financial and Monetary Law*, Vol. 3 (Washington: IMF, 2005), at 669, [http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/bg\\_mk.pdf](http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/bg_mk.pdf).

<sup>4</sup> In the BIS framework, e-money includes prepaid cards (also referred to as electronic purses) and prepaid software products that use computer networks to access the consumer’s account (sometimes called digital cash). Bank for International Settlements, *supra* note 2.

<sup>5</sup> Malte Krueger, “E-Money Regulation in the EU,” in *E-Money and Payment Systems Review* (London: Central Banking, 2002), at 239–51; and Mark Furletti, “Prepaid Cards: How Do They Function? How Are They Regulated?” Federal Reserve Bank of Philadelphia, Payment Cards Center Discussion Paper No. 04-04 (2004), [http://www.phil.frb.org/pcc/papers/Prepaid\\_Cards.pdf](http://www.phil.frb.org/pcc/papers/Prepaid_Cards.pdf).

<sup>6</sup> Electronic payments as defined by the European Central Bank refer to “payments that are initiated, processed and received electronically.” European Central Bank, Issues Paper for the ECB Conference on *E-Payment Without Frontiers* (2004), <http://eps0.intrasoft.lu/papers/ECB%20conference%20epayments%20issues%20paper.pdf>.

<sup>7</sup> Steven Levy, “E-Money (That’s What I Want),” *Wired Magazine*, Issue 2.12 (1994), [http://www.wired.com/wired/archive/2.12/emoney\\_pr.html](http://www.wired.com/wired/archive/2.12/emoney_pr.html); and Congressional Budget Office of the United States, *Emerging Electronic Methods for Making Retail Payments* (1996), <http://www.cbo.gov/showdoc.cfmindex=14&sequence=0>.

<sup>8</sup> Federal Reserve Bank of Dallas, “How Do We Pay,” *Financial Industry Issues*, First Quarter (1997), at 1–8, <http://www.dallasfed.org/banking/fii/fii9701.pdf>; and L.L.S. Siu, “Octopus and Mondex: The Social Shaping of Money, Technology and Consensus,” *Studies of Finance Working Papers*, University of Edinburgh (2002), [http://www.sociology.ed.ac.uk/finance/papers/siu\\_octopus.pdf](http://www.sociology.ed.ac.uk/finance/papers/siu_octopus.pdf).

<sup>9</sup> Commentators have suggested that in the future, state laws might be a source of prudential regulation for nonbank entities engaged in this activity. For example, the United States Consumer Electronic Payments Task Force has noted:

Many commentators have informed the Task Force that they were concerned that e-money issuers would become insolvent, and that consumers would not be informed of their rights in the event of such an insolvency....

Other nonbank issuers may be subject to state regulatory oversight; however, the extent of this supervision is unclear. Clarification by state regulators and legislatures of the applicability of their laws to e-money could be beneficial.

Office of the Comptroller of the Currency, *The Report of the Consumer Electronic Payments Task Force* (April 1998), at 44, <http://www.occ.treas.gov/netbank/ceptrfpt.pdf>.

See also, James McAndrews, “Banking and Payment System Stability in an Electronic Money World,” Federal Reserve Bank of Philadelphia, Working Paper No. 97-9 (1997), <http://www.phil.frb.org/files/wps/1997/wp97-9.pdf>; Barbara Good, “Will Electronic Money Be Adopted in the United States?” Federal Reserve Bank of Cleveland, Working Paper No. 9820 (1998), <http://www.clevelandfed.org/Research/Workpaper/1998/Wp9820.pdf>; and E. Solomon, *Virtual Money: Understanding the Power and Risks of Money’s High-Speed Journey into Electronic Space* (New York: Oxford University Press, 1997).

<sup>10</sup> John D. Muller, “Selected Legal Issues in the Issuance of Electronic Money,” 2(2) *Journal of Internet Banking and Commerce* (1997), <http://www.arraydev.com/commerce/JIBC/9702-17.htm>.

<sup>11</sup> M. Robson, “Electronic Money: Public Policy Issues,” Bank of England, *Financial Stability Review*, No. 1 (Autumn 1996), at 23–30; and Siu, *supra* note 8.

<sup>12</sup> Bank for International Settlements, *supra* note 2.

<sup>13</sup> Michael A. Froomkin, “Flood Control on the Information Ocean: Living With Anonymity, Digital Cash, and Distributed Databases,” *15 University of Pittsburgh Journal of Law and Commerce* (1996), at 395.

<sup>14</sup> Digicash is now referred to as ecash. See European Payment Systems Observatory, *ePSO Database*, <http://www.jrc.es/cfapp/invent/details.cfm?uid=30>.

<sup>15</sup> European Payment Systems Observatory, Database on E-Payment Systems, <http://www.jrc.es/cfapp/invent/details.cfm?uid=24>.

<sup>16</sup> European Central Bank, *supra* note 6.

<sup>17</sup> *Id.*

<sup>18</sup> Federal Reserve proposal to amend Federal Reserve Regulation E to include stored value. See Regulation E—Electronic Funds Transfers, 61 *Federal Register* 19,696 (1996).

<sup>19</sup> European Payment Systems Observatory, Database on E-Payment Systems, <http://www.jrc.es/cfapp/invent/details.cfm?uid=64>.

<sup>20</sup> G. E. Truman, K. Sandoe, and T. Rifkin, “An Empirical Study of Smart Card Technology,” 40(6) *Information & Management* (2003), at 591–606.

<sup>21</sup> Judith Rinearson and Chris Woods, “Beware Strangers Bearing Gift Cards: Some Wholesale Advice for Your Retail Clients,” 14(2) *Business Law Today* (2004), <http://www.abanet.org/buslaw/blt/2004-11-12/woods.shtml>.

<sup>22</sup> Mark Furletti, “Prepaid Card Markets and Regulation,” Federal Reserve Bank of Philadelphia, Payment Cards Center Discussion Paper, No. 01-04 (2004), <http://econpapers.repec.org/paper/fipfedpdp/04-01.htm>; and Rinearson and Woods, *id.*

<sup>23</sup> State legislatures and attorneys general have begun to try to regulate prepaid gift cards from a consumer protection standpoint. In particular, many states have attempted to restrict the way in which card issuers can (1) deduct value from cards for lack of use (dormancy or maintenance fees) and (2) use expiration dates. Such regulations are not prudential regulations and thus are beyond the scope of this chapter.

<sup>24</sup> Julia S. Cheney, “Prepaid Card Models: A Study in Diversity,” Federal Reserve Bank of Philadelphia, Payment Cards Center Discussion Paper No. 05-03 (2005); and Furletti, *supra* note 5.

<sup>25</sup> “Net Currency Seller Files for Bankruptcy,” *New York Times* (September 3, 2001), at C4; and Hugo Godschalk, “Failure of Beenz and Flooz Indicates the End of Digital Web-Currencies?” 10 *Electronic Payment Systems Observatory (ePSO) Newsletter* (November 2001), <http://epso.jrc.es/newsletter/vol10/6.html>.

<sup>26</sup> Godschalk, *id.* See also ePSO Inventory Database on E-Payment Systems for a chronological description of Flooz and Beenz, <http://epso.jrc.es/paysys.html>.

<sup>27</sup> Krueger, *supra* note 5.

<sup>28</sup> ePSO Inventory Database on E-Payment Systems, <http://www.jrc.es/cfapp/invent/details.cfm?uid=83>. See also the PayPal website, <http://www.paypal.com>.

<sup>29</sup> e-gold Ltd. website, <http://www.e-gold.com>. See also ePSO Inventory description of E-gold at <http://www.jrc.es/cfapp/invent/details.cfm?uid=74>.

<sup>30</sup> European Commission, “Application of the E-money Directive to Mobile Operators,” Consultation Paper of the DG Internal Market (2004), [http://europa.eu.int/comm/internal\\_market/bank/docs/e-money/2004-05-consultation\\_en.pdf](http://europa.eu.int/comm/internal_market/bank/docs/e-money/2004-05-consultation_en.pdf).

<sup>31</sup> Mobile Payment Forum, “Ensuring Interoperable and User-Friendly Mobile Payments,” White Paper (2002), [http://www.mobilepaymentforum.org/pdfs/mpf\\_whitepaper.pdf](http://www.mobilepaymentforum.org/pdfs/mpf_whitepaper.pdf).

<sup>32</sup> Office of the Comptroller of the Currency, *supra* note 9.

<sup>33</sup> Muller, *supra* note 10.

<sup>34</sup> Office of the Comptroller of the Currency, “Interpretations, Conditional Approval #220 (Mondex), December 12, 1996,” in *Interpretations and Actions* (December 1996), <http://www.occ.treas.gov/interp/nov/conda220.htm>.

<sup>35</sup> Office of the Comptroller of the Currency, *supra* note 9; and Manfred Kohlbach, “Making Sense of Electronic Money,” 2004(1) *Journal of Information Technology and Law*, [http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2004\\_1/kohlbach](http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2004_1/kohlbach).

<sup>36</sup> Recent proposals to regulate prepaid cards at the federal level include expanding the scope of Federal Reserve Regulation E to encompass employer provided payroll cards: 69(180) *Federal Register* (September 17, 2004); and the Federal Deposit Insurance Corporation’s proposal to clarify whether the



funds held by issuers or prepaid cards constituted “deposits” for purposes of the FDIC Act. *See* 69(74) *Federal Register* (April 16, 2004), <http://www.fdic.gov/news/news/press/2005/pr6505.html>; and Federal Reserve Board, “A Summary of the Roundtable Discussion on Stored-Value Cards and Other Prepaid Products” (November 2004), <http://www.federalreserve.gov/paymentsystems/storedvalue/>.

<sup>37</sup> For a summary of the early phases of PayPal’s development, see ePSO Inventory Database on E-Payment Systems at <http://www.jrc.es/cfapp/invent/details.cfm?uid=83>. PayPal was acquired by online auction site eBay in October 2002. *See* PayPal website “About Us,” <http://www.paypal.com/cgi-bin/webscr?cmd=p/gen/about-outside>; and Jeffrey D. Jordan, “Innovations Keynote Address,” Federal Reserve Bank of Chicago 2005 Payments Conference, [http://www.chicagofed.org/news\\_and\\_conferences/conferences\\_and\\_events/files/2005\\_payments\\_jordan.pdf](http://www.chicagofed.org/news_and_conferences/conferences_and_events/files/2005_payments_jordan.pdf).

<sup>38</sup> Rinearson and Woods, *supra* note 21; and John Morgan, “Legal Implications of Stored-Value Cards,” Perkins Coie Client Update (January 2005), <http://www.aals.org/am2005/saturdaypapers/830morgan3.pdf>.

<sup>39</sup> Krueger, *supra* note 5; and Kohlbach *supra* note 35.

<sup>40</sup> For further information on the U.S. Treasury Department’s regulation of money services businesses for compliance with the federal Bank Secrecy Act, see <http://www.msb.gov>.

<sup>41</sup> Judith Rinearson, “Regulation of Electronic Stored-Value Payment Products Issued by Nonbanks Under State ‘Money Transmitter’ Licensing Laws,” 58 *Business Lawyer* (November 2002), at 317.

<sup>42</sup> Coopers and Lybrand, “Non-Bank Financial Institutions: A Study of Five Sectors Prepared for the Financial Crimes Enforcement Network” (February 1997), <http://www.fincen.gov/cooply.html>.

<sup>43</sup> Definition and Registration of Money Service Businesses, 62 *Federal Register* 27,890 (May 21, 1997). *See* Anita Ramasastry, “Memorandum to Drafting Committee, Proposed Nondepository Providers of Financial Services Act, National Conference of Commissioners on Uniform State Laws on Overview of Relevant Legislation and Regulations” (October 13, 1997), <http://www.law.upenn.edu/bll/ulc/ndpfsa/ndp1097.htm>.

<sup>44</sup> National Conference of Commissioners on Uniform State Laws, *Uniform Money Services Act* [hereinafter UMSA] (2001), <http://www.law.upenn.edu/bll/ulc/moneyserv/UMSA2001final.pdf>.

<sup>45</sup> Ramasastry, *supra* note 43.

<sup>46</sup> For recent developments at the state level, see the MTRA website, <http://www.mtraweb.org>.

<sup>47</sup> Anita Ramasastry, “Memorandum to Cyberpayments Working Group of the Uniform Money Services Business Act Drafting Committee on Issues to Be Considered by the Working Group” (January 5, 2000), <http://www.law.upenn.edu/bll/ulc/moneyserv/cyberpayments.html>.

<sup>48</sup> Anita Ramasastry and Tom Bolt, “Questions and Answers About the Uniform Money Services Act” (June 15, 2000), <http://www.law.upenn.edu/bll/ulc/moneyserv/msbQA0620.htm>.

<sup>49</sup> Ramasastry, *supra* note 43.

<sup>50</sup> UMSA, *supra* note 44.

<sup>51</sup> For the current status of the UMSA and its adoption by the states, see <http://www.nccusl.org>.

<sup>52</sup> Various states have included stored value within their existing money transmission law. Connecticut, for example, has defined stored value as a form of “electronic payment instrument.” Conn Gen Stat. Ann. 36a-596 (West Supp. 2001). West Virginia defines “currency transmission” or “money transmission” to include “the transmission of funds through the issuance and sale of stored-value cards which are intended for general acceptance and use in commercial or consumer transactions.” W. Va. Code 32A-2-1(6) (West 1999). Other states, such as Texas, have included stored-value providers by interpretation. The Texas Banking Department has explained, for example, its rationale for requiring nonbank issuers of open system stored-value cards to obtain a license under the Texas Sale of Checks Act:

Stored-value cards issued by nonbanks for use in “open” systems (i.e., to purchase goods and services offered by vendors other than the issuer of the card) will generally be subject to regulation under the Sale of Checks Act because the nonbank issuer is holding the funds of third parties. Consumers are relying on the nonbank issuer that the card will be honored when presented by the purchaser of goods and services at diverse locations.

See Remarks of Catherine A. Ghiglieri, Texas Department of Banking the PULSE EFT Assoc. Member Conference (October 11, 1996), <http://www.banking.stat.tx.us/exec/speech10a.htm>.

<sup>53</sup> UMSA § 102(10).

<sup>54</sup> As of October 17, 2005, PayPal indicated that it is licensed in 34 states. See <http://www.paypal.com/cgi-bin/webscr?cmd=p/ir/licenses-outside>.

<sup>55</sup> To locate where the UMSA has been adopted, see NCCUSL's website, <http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=2&tabid=60>.

<sup>56</sup> ePSO Inventory Database on E-Payment Systems, <http://epso.jrc.es/paysys.html>; and A. Ramasastry, "E-Payments Regulation and Innovation in the U.S. and Assessment of State Regulatory Practice and Perception," presentation for European Payment Systems Observatory Conference on Consumer Online Payments: Trends and Challenges for Europe (February 2002), <http://epso.jrc.es/conference/presentations/ps1/ramasastry.pdf>.

<sup>57</sup> Federal Reserve, *The Future of Retail Electronic Payments Systems: Industry Interviews and Analysis*, Staff Study 175 (December 2002), <http://www.federalreserve.gov/pubs/staffstudies/200-present/55175.pdf>.

<sup>58</sup> UMSA would allow any type of licensed MSB to operate in other jurisdictions on the basis of a single license granted by a lead regulator, as long as the states in which the MSB conducts business have laws that are substantially similar to those in the home licensing state. National Conference of Commissioners on Uniform State Laws, *Amendments to Uniform Money Services Act* (2004) [hereinafter UMSA Amendments], <http://www.law.upenn.edu/bll/ulc/moneyserv/approvedfinal2004.htm>.

<sup>59</sup> See, e.g., the MTRA's Money Transmitter Regulators' Cooperative Agreement (2002), [http://www.mtraweb.org/coop\\_agr.shtm](http://www.mtraweb.org/coop_agr.shtm).

<sup>60</sup> Simon Lelieveldt, "The Electronic Money Directive: Recapitulation and Outlook," Working Paper prepared for the GTIAD meeting (November 27, 2003), Amsterdam, on behalf of the Association of Electronic Money Issuers in the Netherlands, <http://www.simonl.org/docs/pp221103.doc>.

<sup>61</sup> *Id.*

<sup>62</sup> L. Van Hove, "Electronic Purses: (Which) Way to Go?" *5(7) First Monday* (July 2000), [http://www.firstmonday.org/issues/issues5\\_7/hove/index.html](http://www.firstmonday.org/issues/issues5_7/hove/index.html).

<sup>63</sup> The European Monetary Institute, the precursor for the European Central Bank, met for the first time on January 12, 1994.

<sup>64</sup> European Monetary Institute, *Report to the Council of the European Monetary Institute on Prepaid Cards* (May 1994).

<sup>65</sup> In the United States, individual banking regulators have taken similar positions that nonbank issuers were "accepting deposits" when taking consumer funds for the purpose of funds transmission or in exchange for the issuance of a stored-value card. See, e.g., New York State Banking Department, staff interpretation, Opinion regarding PayPal Activities (June 3, 2002), <http://www.banking.state.ny.us/legal/lo020603.htm>.

<sup>66</sup> Lelieveldt, *supra* note 60.

<sup>67</sup> The draft and final directives are formally titled the “EU Directive on the Taking Up, Pursuit of and Prudential Supervision of the Business of Electronic Money Institutions.”

<sup>68</sup> Krueger, *supra* note 5.

<sup>69</sup> Art. 3(b), 2000/46/EC of the European Council and Parliament of Ministers of 18 September 2000 on the Taking Up, Pursuit of and Prudential Supervision of the Business of Electronic Money Institutions, in *Official Journal of the European Communities*, L275 (October 27, 2000), at 39–43. [http://www.europa.eu.int/eur-lex/pri/en/oj/dat/2000/l\\_275/l\\_27520001027en00390043.pdf](http://www.europa.eu.int/eur-lex/pri/en/oj/dat/2000/l_275/l_27520001027en00390043.pdf) [hereinafter “E-Money Directive”].

<sup>70</sup> Marc Vereecken, “A Harmonized EU Legal Framework for Electronic Money,” 7 *ePSO Newsletter* (May 2001), <http://epso.jrc.es/newsletter/vol07/docs/ePSO-N.pdf>; and Rufus Pichler, “The European Electronic Money Directive and the U.S. Uniform Money Services Act—The Similarities and Differences,” 11 *ePSO Newsletter* (November 2001), <http://epso.jrc.es/newsletter/vol11/6.html>.

<sup>71</sup> Art. 1(3)(a), E-Money Directive, *supra* note 69.

<sup>72</sup> Kohlbach, *supra* note 35.

<sup>73</sup> Art. 2(3), Directive 2000/46/EC, *supra* note 69.

<sup>74</sup> Kohlbach, *supra* note 35, citing J. Chuah, “The New EU Directives to Regulate Electronic Money Institutions—A Critique of the EU’s Approach to Electronic Money,” 5(8) *Journal of International Banking* 180, at 183 (2000). See also W.R.M. Long and J.M. Casanova, “European Initiatives for Online Financial Services, Part 2: Financial Services and the Regulation of Electronic Money,” 18(1) *Butterworths Journal of International Banking and Financial Law* 8 (January 2003).

<sup>75</sup> As recently as 2003, the European Commission noted that it would send opinions to Belgium, Finland, France, and Greece for failing to adopt the measures necessary to comply with the E-Money Directive. Thus, implementation of the directive has not been as rapid as anticipated. (IP/03/4). European Commission Press Release, “Commission Moves Against 13 member states for Failure to Implement EU Legislation” (January 6, 2003), <http://europa.eu.int/rapid/pressreleasesaction.do?reference=IP/03/4&format=HTML&aged=1&language=EN&guiLanguage=en>. See also European Central Bank, “E-payments in Europe—The Eurosystem’s Perspective” (September 2002), at 21 (noting that only 10 member states had imple-

mented the E-Money Directive as of August 2002), <http://www.ecb.int/events/pdf/conferences/epayments.pdf>.

<sup>76</sup> The European Central Bank (ECB) notes that: “The definitions of e-money in local regulations and supervisory approaches vary considerably as well. Some countries have specified maximum amounts of e-money that may be stored on an electronic device. In some national laws specific clauses confirm that the funds that e-money issuers receive from the public in exchange for e-money values do not constitute a deposit. In other countries, however, e-money has been interpreted so widely that hardly any criteria or a consistent differentiation remain, especially in the context of the different definitions of [EMIs] partly as credit institutions, partly as service providers.” ECB, Issues Paper for the ECB Conference on *E-Payment Without Frontiers* (2004), <http://epso.intrasoft.lu/papers/ECB%20conference%20epayments%20issues%20paper.pdf>. See also, Lelieveldt, *supra* note 60.

<sup>77</sup> ECB, *id.*

<sup>78</sup> G. Bamodu, “The Regulation of Electronic Money Institutions in the United Kingdom,” 2003(2) *Journal of Information, Law and Technology*.

<sup>79</sup> Kohlbach, *supra* note 35.

<sup>80</sup> European Commission, “Questionnaire on the Electronic Money Directive,” 2000/46/EC (July 14, 2005), [http://europa.eu.int/comm/internal\\_market/bank/docs/e-money/questionnaire\\_en.pdf](http://europa.eu.int/comm/internal_market/bank/docs/e-money/questionnaire_en.pdf).

<sup>81</sup> Godschalk, *supra* note 25; and Lelieveldt, *supra* note 60.

<sup>82</sup> Danish Ministry of Science, Technology and Innovation, “Barriers to Electronic Payments,” Discussion Paper (October 2004), <http://www.vtu.dk/fsk/ITC/Diskussionspapir14102004.pdf>.

<sup>83</sup> Krueger, *supra* note 5; and H. Godschalk and M. Krueger, “Why E-Money Still Fails: Chances of E-Money Within a Competitive Payment Instrument Market,” paper prepared for the Third Berlin Internet Economics Workshop (May 26, 2000), <http://www.berlecon/services/en/iew3/papers/godschalk.pdf>.

<sup>84</sup> Kohlbach, *supra* note 35.

<sup>85</sup> European Commission, *Application of the E-Money Directive to Mobile Operators*, Consultation Paper of the DG Internal Market (2004), [http://europa.eu.int/comm/internal\\_market/bank/docs/e-money/2004-05-consultation\\_en.pdf](http://europa.eu.int/comm/internal_market/bank/docs/e-money/2004-05-consultation_en.pdf).

<sup>86</sup> Kohlbach, *supra* note 35.

<sup>87</sup> Although the official commentary to the UMSA makes reference to the E-Money Directive, the comments were drafted after the National Conference of Commissioners on Uniform State Laws had adopted the Act. The Drafting Committee deliberated without review of the E-Money Directive or any related white papers or commentary.

<sup>88</sup> Rufus Pilcher, “The European Electronic Money Institutions Directive and the U.S. Uniform Money Services Act—The Similarities and Differences,” 11 *ePSO Newsletter* (November 2001), <http://epsso.jrc.es/nesletter/vol11/6.html>.

<sup>89</sup> UMSA, *supra* note 44.

<sup>90</sup> Pilcher, *supra* note 88.

<sup>91</sup> UMSA, § 102(10).

<sup>92</sup> The commentary to the UMSA provides some guidance as to what is meant by a “medium of exchange”:

Monetary value is defined as “a medium of exchange, whether or not redeemable in money.” The term “medium of exchange” connotes that the value that is being exchanged be accepted by a community, larger than the two parties to the exchange. Hence, bilateral units of account, such as university payment cards, would not constitute “monetary value” for purposes of this Act. A university payment card that was also accepted by a few local pizzerias could be at the borderline. A university payment card accepted by most local merchants would likely be “monetary value.” The definition of monetary value, to some extent, must remain flexible to allow regulators to deal with emerging forms of monetary value and Internet “scrip” on a case-by-case basis. It is possible, therefore, that a certain type of monetary value of stored-value might not constitute a medium of exchange when first introduced, but might evolve into a more commonly accepted form of payment and would become a medium of exchange. UMSA, § 102(10).

In effect, the term “medium of exchange” is meant to indicate that when an e-money or stored-value system looks more like currency (in terms of its wide acceptance as a means of payment), it poses certain safety and soundness concerns not apparent with small, limited purpose payment systems.

<sup>93</sup> Pilcher, *supra* note 88.

<sup>94</sup> Both instruments require the EMIs (Art. 5 EMI Directive) or MSBs (§ 701 UMSA), respectively, to maintain investments at all times at least in the amount of their outstanding liabilities arising from issued and outstanding electronic money or stored value. Further, both instruments define permissi-

ble, low-risk investments (Art. 5 EMI Directive and § 702 UMSA). Pilcher, *supra* note 88.

<sup>95</sup> UMSA, § 206.

<sup>96</sup> Pilcher, *supra* note 88.

<sup>97</sup> Monica Hartmann's presentation on behalf of the European Central Bank in 2004 shows that card-based e-money schemes accounted for only 1 percent of cashless payment transactions in 2002 in 25 EU member states. Credit card and debit cards, by contrast, constituted 31 percent of those transactions. M. Hartmann, "What Is New with Innovative Payments," presentation prepared for the ECB Conference *E-payments Without Frontiers* (November 10, 2004), [http://www.ecb.int/events/pdf/conferences/epayments2004/041110\\_econf\\_hartmann.pdf](http://www.ecb.int/events/pdf/conferences/epayments2004/041110_econf_hartmann.pdf).

<sup>98</sup> Kohlbach, *supra* note 35.

<sup>99</sup> B. Mantel, "Why Do Consumers Pay Bills Electronically? An Empirical Analysis," 24(4) *Economic Perspective* of the Federal Reserve Bank of Chicago (2000), <http://www.chicagofed.org/publications/economicperspectives/2000/4qep3.pdf>.

<sup>100</sup> *Id.*

<sup>101</sup> ECB, *supra* note 6.

<sup>102</sup> S. Chakravorti, "Why Has Stored Value Not Caught On?" *Emerging Issues* of the Federal Reserve Bank of Chicago (May 2000), <http://www.chicagofed.org/publications/publicpolicystudies/emergingissues/pdf/S&R-2000-6.pdf>; and R. Mann, "Making Sense of Payments Policy in the Information Age," 93 *Georgetown Law Journal* 633 (2005).

<sup>103</sup> Krueger, *supra* note 5.

<sup>104</sup> Mantel, *supra* note 99.

<sup>105</sup> Bank for International Settlements, *supra* note 2; and B. Mantel and T. McHugh, "Evolving E-payment Networks: The Strategic, Competitive, and Innovative Implications," 13(1) *Payment Systems Worldwide* 4 (Spring 2002).

<sup>106</sup> K. Böhle and M. Krueger, "Payment Culture Matters—A Comparative EU-U.S. Perspective on Internet Payments," ePSO Background Paper No. 4 (August 2001), <http://epso.jrc.es/Docs/Backgrnd-4.pdf>.

<sup>107</sup> Barbara A. Good, "Electronic Money," Federal Reserve Bank of Cleveland Working Paper 97/16 (1997), <http://www.clevelandfed.org/research/workingpaper/1997/wp9716.pdf>.

<sup>108</sup> Chakravorti, *supra* note 102.



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MARK FAJFAR

In the past decade, methods of effecting banking and other financial transactions via the Internet in the United States have quickly become more and more sophisticated. This chapter will examine, from the viewpoint of a U.S. legal practitioner, the implications of this trend toward conducting financial transactions electronically. The focus of this chapter is not on legal theories, but rather on the interesting and novel practical issues that arise in the legal implementation of new electronic payment systems that are now more prevalent or are appearing on the horizon. The chapter discusses consumer, as opposed to business-to-business, transactions and concentrates on how the particular characteristics of the new electronic payment systems (contrasted to the “traditional systems”) affect the consideration of two issues: information security and efforts against money laundering and terrorist financing.

A “silent revolution” in the payment systems in the United States has occurred over the past decade or so. Payment systems are moving from paper toward real-time, electronic execution and settlement. “Real-time” means that payments are settled or cleared not only in a few days or even overnight, but on a continuous basis, 24 hours a day. Consumers have generally been willing to adopt these new electronic systems because they have confidence in the financial system in general and in electronic operations in particular. But this is a silent revolution because these extensive changes have occurred slowly, and not necessarily in ways that are obvious or dramatic. The traditional, trusted, and convenient means of effecting payments still have a strong attraction to consumers, who therefore change their economic behavior slowly because of their emotional relationship to money and the payment mechanisms they trust.

## **Overview of New Electronic Payment Systems**

Before addressing the security and law enforcement implications of the new payment systems, this discussion will briefly describe the new systems themselves. As a preliminary aside, the reader should note that a detailed analysis of the credit and debit card systems is beyond the scope of the discussion for two reasons. First, credit and debit cards are so pervasive a means of effecting electronic transactions in the United States that an examination of them would at least double the length of the discussion. Second, the discussion aims to address recent changes in the electronic payment systems and the implications of those changes on the issues of information security, money laundering, and terrorist financing. While they are important, the credit and debit card systems are not especially changing at this time (and to the extent they are, they will be discussed). Nonetheless, the credit and debit card payment systems are a crucial part of the overall U.S. consumer finance structure, and much of the discussion of information security and other concerns does apply to credit and debit cards.

## **Transformation of the Paper Check**

The silent revolution in payment systems in the United States is most apparent in the ongoing transformation of the paper bank check, which has been for decades the mainstay of the consumer payment system. The demise of the paper check has been predicted since at least the 1960s, but its familiarity, simplicity, and consumer protections have fostered its continued use, and a very large percentage of payments are effected today by paper checks.

Electronic processing of check transactions has accelerated; however, the primary change has been the increasing use of the automated clearinghouse (ACH) system for direct deposits and direct payments. Common uses are the direct deposit of payroll checks and consumer payment of recurring bills by direct payments to utilities, for example. Furthermore, these systems are evolving into a comprehensive system of electronic bill presentment and payment, which permit a consumer to register (typically through a bank, but also through third-party service providers) to receive bills from a variety of merchants by electronic mail, rather than postal mail. Then,

instead of using checks, the consumer uses the Internet to initiate direct electronic payments to those merchants.

The important lesson from the transformation of the paper check is that it reflects a gradual expansion of an electronic system. In the early stages, the ACH system was used for only repetitive payments to specific merchants. Today, this electronic system encompasses the billing process and payments to a variety of merchants.

There is also much discussion today of the Check Clearing for the 21st Century Act, Pub. L. No. 108-100, 117 Stat. 1177 (2003) (“Check 21 Act”), which will permit “electronic check truncation.” That is, banks will be permitted to convert paper checks to electronic entries, and process the check transaction electronically, without the physical delivery of checks from place to place.

### **Electronic Payment of Government Benefits**

Another new application of electronic payment systems is their use to provide government benefits. Already, federal, state, and local governments favor the ACH direct deposit system for payments to individuals, such as tax refunds, social security benefits, and cash assistance. While that system is relatively straightforward, difficult issues arise when governments seek to make electronic payments to people who do not have bank accounts (which constitute a significant number of lower-income individuals). For them, the existing paper check-based system imposes costs on both the government-payor and the recipient. The government has to pay for the printing and mailing of checks, and the individual recipient has to pay the cost of a check cashing service.

For this reason, governments have started to pay benefits in the form of debit cards known as electronic benefits cards. These are similar to cards used at automated teller machines (ATMs). The electronic benefits cards are periodically loaded with additional funds by the government (i.e., the government deposits funds into a bank account tied to the cards). Individuals use the cards to make purchases in stores or to withdraw cash from ATMs.

The interesting point here is that the large volume of government payments is likely to hasten the acceptance of debit cards as a means

of transferring funds to individuals. Similar systems are sometimes used for payroll, especially the payment of wages to transient or temporary workers. The issue of whether debit cards, as their use to transfer funds to individuals becomes more common, could also be used for money laundering or terrorist financing is addressed later in the discussion.

### **Person-to-Person Electronic Payment Systems**

The previous two examples are illustrations of the evolution of an existing system into a new, electronic format. In addition, other electronic payment systems have introduced entirely new ways to transfer funds between individuals.

For example, person-to-person electronic payment systems, such as PayPal, are used to transfer funds electronically among individuals without using cash or checks. Basically, these systems require that each user designate a bank account or a credit card account. Then, when an individual initiates an electronic transfer to another individual, PayPal's electronic system causes a debit in the account of the payor and a credit in the account of the payee.

Many similar systems were introduced during the technology boom of the late 1990s. Those that remain viable found success in niche markets, such as facilitating purchases between individuals on Internet auction sites like eBay. The advantages of these systems are that they clear payments faster than check processing systems, do not impose the high fees of credit cards, and do not impose merchant-qualification requirements. Instead, anyone with a bank account or credit card can use a PayPal account to receive money electronically from other individuals.

### **“Closed-System” Stored-Value Cards**

A wide variety of new electronic stored-value cards that defy easy classification under traditional rules and regulations have recently appeared. For example, electronic gift cards issued for a particular value by a particular merchant have become very popular. The card can be given as a gift, or just used as a convenient way to make purchases at the merchant later on. Ease of use and convenience are the primary attraction of these cards to consumers, while merchants favor

them because customers tend to spend more freely when using a gift card (probably because of the disconnection between the payment of money and the use of the card).

Similar cards are issued by the larger urban mass transit systems, universities, and other “campus-based” organizations to permit users to make payments within the issuing system. Typically, the consumer loads a certain amount of money onto the stored-value card (using cash or a credit or debit card) and then spends that amount over time. The Washington Metropolitan Area Transit Authority uses an electronic stored-value card, for example, and the EZ-Pass and other systems for toll roads are prevalent in large cities throughout the United States. All of these systems are primarily for relatively low-value transactions. They are called “closed-system” stored-value cards because their use is usually limited to a single merchant or organization.

### **“Open” or “Universal” Stored-Value Cards**

Open or universal electronic stored-value cards—that is, those that can be used at a large number of locations of diverse types—have so far failed to succeed in the United States because there simply does not appear to be demand for a new electronic alternative to cash. The existing credit card, debit card, and ATM systems already meet this demand, since they are convenient, inexpensive, and widely available.

### **“High-Velocity” Payment Systems**

Looking to the future, however, the new systems that we anticipate will likely succeed could be called “high-velocity” payment systems. Private or quasi-public electronic payment networks, such as highway toll pass and urban mass transit fare pass cards, are becoming more sophisticated and are being used by more consumers. Similarly, some merchants are attempting to expand the use of stored-value cards they issue. In some trials, these cards can be used at a wider variety of locations. That is, they are transforming from closed systems to open systems. Mobile telephone service providers are entering the field with nascent offerings, which may yet overcome the lack of industry standards and other practical challenges.

These systems are designed to be transparent to the consumer, and their focus is on repetitive, low-value payments where speed and

convenience are the primary goal. The twist they add to the merchant-specific cards is that they hope to offer consumers the ability to make payments at a wide variety of locations. It is likely that in the near future these products will add more features and expanded functions in order to be more widely accepted. In doing so, they face the same challenges that faced Mondex, CyberCash, DigiCash, and other systems in the 1990s.

### **Acceptance of Electronic Payments in the U.S. Financial System**

The issue in all the new electronic payment systems described above, that is, the problem they all face, is whether and how they will effectively replace all the functions of the paper cash and check systems, including their familiarity and acceptance by consumers. In thinking about this issue, it is helpful to consider two particular characteristics of the U.S. financial system that have affected how electronic payment systems have been implemented and gained acceptance to date.

The first important characteristic of the U.S. payment systems is that they are, as a practical matter, regulated not only by government laws and regulations, but also by the internal rules of private organizations, which apply to the settlement of checks, credit cards, and other payment devices. That is, banks and merchants agree on a voluntary basis to abide by the rules of, for example, the National Automated Clearing House Association, which governs check processing, and the rules of Visa, MasterCard, American Express, and Discover, the main credit card organizations. These rules are, in turn, imposed on consumers when they agree to the terms and conditions of a bank account or credit card account that is governed by the rules.

For example, the rules of these private organizations resolve disputes regarding which party is liable for unauthorized transactions, or for authorized transactions that are not completed due to some error. For the large part, these rules provide that the consumer is not liable for unauthorized or erroneous transactions, which of course makes these systems more attractive to the consumer. The widespread acceptance by all parties (consumers, merchants, financial institutions, and regulators) of the compromises reflected in these rules is one of the strengths of the currently predominant systems.

The second important characteristic of the U.S. payment systems is that they have not experienced any large or systemic failure within the past generation. While there have been scandals such as the savings and loan failures in the 1980s and the recent corporate accounting and governance scandals, neither have involved large-scale losses to consumers. Similarly, the financial system recently withstood the Y2K problem and the September 11th attacks. Therefore, it is safe to say that U.S. consumers generally have a high degree of confidence in banks, credit cards, and electronic payment systems, and therefore are willing to try new systems as they are offered.

### **Can New Systems Effectively Replace Paper Systems?**

Because of these two characteristics of U.S. payment systems, the operational challenge for the new electronic payment systems is to develop and maintain a private system of rules that replicates all of the functions of the traditional payment systems and also provides advantages over them. Over the long run, we believe the new systems will reduce costs and increase efficiency, but the short-term price may be some confusion in the absence of ground rules that are well-understood by consumers, businesses, financial institutions, and regulators. The competition between the different systems to develop fair and effective rules is likely to benefit all parties involved rather than being a race to the bottom. In any case, it is clear that wider acceptance of the new payment products will require the development of universal standards, technologies, and rules, which has not yet occurred.

From a legal perspective, the fundamental issue that the appearance of new alternatives to the traditional payment systems has raised for governments and financial regulators is the question of whether it is feasible to allow a mix of divergent commercial organizations to each have an effect on the nation's payment system, that is, its "money." Before the appearance of new and, to some extent, less regulated electronic payment systems in the 1990s, regulators did not have to ask themselves this question. To the extent they pay attention to this issue now, there is a possibility that laws will be changed to accommodate the new systems.



## **Information Security and Money Laundering and Terrorist Financing**

The specific challenges addressed in the remainder of the discussion focus on how the new payment systems will deal with the issues of information security and money laundering and terrorist financing.

We believe that information security aspects of the new electronic payment systems will, for the next few years at least, be an area of increasing concern to consumers, merchants, financial institutions, and regulators. In this context, the term “information security” refers to efforts to protect electronic payment systems from the relevant threats.

On a basic level, what are the threats that are of concern?

- An individual will break into an electronic system in order to initiate unauthorized transactions on another individual’s legitimate account, thereby stealing money.
- An individual will steal customers’ personal data, enabling the wrongdoer to set up illegitimate credit card accounts, bank accounts, and other accounts—this is called identity theft.
- An individual will attack or corrupt the data in the electronic system, either as vandalism or to extort money from the sponsoring financial institutions.
- An individual will take advantage of the convenience and speed of the electronic system to mask illegitimate or illegal transactions (i.e., money laundering).
- An individual will take advantage of the efficiency of the electronic system to facilitate funding of illegal activities, particularly terrorism.

It is also useful to consider not only these specific threats, but also the underlying themes that are of particular concern in recent years. Three such themes are terrorism, identity theft, and internal fraud (i.e., fraud committed by employees or other insiders in the organization).

## **Systemic Measures to Secure Electronic Payment Systems**

Obviously, sophisticated electronic systems and technical procedures exist that can be used to counter each of the threats mentioned above. But from a legal perspective, the primary area of concern is not the technical details, but instead the measures taken at a systemic level by financial institutions and other organizations to protect their electronic payment systems. Lawyers look at the security system as a whole in order to understand the framework in which these security measures will be evaluated. Lawyers focus on the fact that, at some point, a third party will examine the merchant or financial institution to determine whether its electronic payment systems are sufficiently secure. This third party could be a bank regulator conducting a periodic examination, or an independent auditor, or an adverse party in litigation, or an internal investigation conducted by the organization itself. The point is to consider *now* the factors that will be important in that examination *later* and to consider steps the organization should take *now* so that its systems will be in compliance *later*. Lawyers cannot wait for a problem to occur in order to attempt to fix it.

### **Electronic Payment Systems Require Remote Interaction**

The analysis of information security requires an understanding of the underlying characteristics of electronic payment systems that increase their vulnerability to security threats. For example, it is important to understand that remote interaction is crucial to electronic payment systems. At its core, any electronic payment system is based on an ability to query a database of financial information from a distance, and then cause that database to be modified (e.g., by making debit and credit entries) to reflect a transaction. But this remote interaction is also the characteristic that renders electronic payment systems vulnerable to fraud, hacking, and other disruptions. This risk is becoming of greater concern as users demand continuous access to their funds and ever faster transaction completion.

Consider the practical implications of this remote interaction. In the traditional systems, financial transactions were initiated and completed by bank personnel, using proprietary systems located at the bank. Network connections to other banks occurred, but were the exception more than the rule. Many transactions were cleared based on paper documents (such as a check), with a higher degree of oversight

by a human being. Currently, we are in the midst of rapid changes in these systems:

- Financial transactions are initiated and completed by customers themselves, using computers that are connected to the bank's systems via the Internet. This can include very high value transactions.
- Network connections between systems of different banks are pervasive and virtually constant. Moreover, the U.S. financial system as a whole is dependent on these connections.
- Fewer and fewer transactions are cleared on a paper basis. And virtually no high-value transactions are paper-based.
- There is less and less human oversight of computers that clear transactions, that is, such operations are becoming more and more automated as the computer hardware and software becomes more sophisticated and autonomous.

### **Steps to Information Security Compliance**

What are some of the steps that are recommended to secure electronic payment systems, in light of these changes and the resulting threats to the system? We refer to these steps as “information security compliance.”

- Security efforts must be risk-based. The company or financial institution must evaluate the threats to its information assets and concentrate on counteracting those that involve the highest risk of severe adverse consequences.
- Security efforts must be continuous. Compliance measures must be periodically tested, reevaluated, and modified to maintain their effectiveness. For example, errors may arise when a company or institution hires new employees, opens a new branch, or enters a new business without updating its security controls to account for the new activities. Similarly, when employees leave, branches close, or businesses wind up, the information systems devoted to those past activities must be properly cleansed.
- Security efforts must cover the entire organization. Specific practices and the compliance culture must be overseen by the board of directors and extend to the lowest level of employee with opera-

tional responsibility. In particular, the compliance program must take into account that human error (whether negligence or willful misconduct) is the greatest threat to information assets. There must be rigorous training of employees.

- Information systems must permit later auditing in order to detect efforts to alter or compromise information. Just as the “black box” is crucial to the investigation of a plane accident, there must be some means of reviewing how the information systems have actually been used and what they have actually done. If not, the organization will be unable to determine whether information security breaches have occurred, let alone determine how to prevent them.
- Third-party service providers must be held to the high standards. Many information systems tasks are subcontracted (or “outsourced”) to third-party service providers that are able to perform these services more efficiently. But responsibility for information security cannot also be subcontracted. On the contrary, these arrangements require close attention to the subcontractor’s performance. In particular, the subcontractor should be subject to a written obligation that it meet all of the information security compliance standards of the hiring company or financial institution.

### **Manage Information Security as Part of Overall Legal Compliance**

Last, and most important, it must be understood that the goal is not to create a list of compliance steps, and then conclude that if each of those actions is completed, the electronic system will be sufficiently secure. Instead, electronic payment systems need to be made secure as part of the organization’s overall legal compliance effort. For example, decisions about what specific hardware or software measures to take need to be made in a rational way and documented, so that when the security of the system is later examined by a regulator or third party, the institution will be able to explain why it took certain steps and not others. This cannot be haphazard. Similarly, it is important to maintain access controls and logs, so that it is possible to examine how the system is used—to understand, for example, how a security breach occurred, to what extent information was compro-

mised, and so forth. Even the most up-to-date security systems are much less valuable if there is no record of how they were installed, how they have been operated, and how they may have failed.

### **Money Laundering and Terrorist Financing**

Turning now to money laundering and terrorist financing concerns, and recognizing the difficulty of covering all facets of such a broad topic, the discussion will instead consider how these concerns are implicated in the new electronic payment systems.

It is helpful to begin with a simple example. An individual in the United States can open a bank account over the Internet, generally by providing a name, social security number, and address, without entering a bank office. The individual could then transfer any sum of money into the account electronically. Money could be transferred from the United States or from overseas. Using the account, the individual could purchase stored-value cards offered by credit card systems and others and mail those cards overseas. Persons in other countries, who, let us assume, would be prohibited from opening a bank account in the United States, could then use the cards to purchase goods and services using funds in a U.S. bank account. (The important question of whether use of the stored-value cards would require the presentation of identification is a question of local regulation and practice.) Similarly, persons overseas could access cash in the U.S. bank account overseas by using an ATM card linked to the account, which typically does not require the presentation of identification.

What are the facets of this example that are unique to the new electronic payment systems? The first point is that as stored-value cards gradually become more prevalent, common, and accepted, their use becomes routine and does not draw attention. The second point is that none of the individuals involved in the example described above would have any interaction with a bank employee. So there is no question of a bank employee “noticing anything suspicious” about them, the account, or the transactions. The third point is that, in this example, an electronic network is the crucial choke point. That is, since there is no person-to-person interaction, we must rely on an electronic computer network to detect illegal activity. Presumably, the bank or credit card networks involved in the transactions would use software to flag the fact that an individual was repeatedly buying

stored-value cards that are being used overseas, or that ATM withdrawals are repeatedly being made overseas. This itself raises a number of interesting points:

- First, this would be a proprietary, commercial system. At this point, law enforcement agencies are not involved and we depend on the competence of the financial institution to detect suspicious activity.
- Second, an obvious issue concerns where to set the threshold—that is, at what point is activity deemed suspicious? It is crucial that the threshold be set at an appropriate point to avoid missing illegal activity or raising the alarm too frequently.
- Third, it is important to bear in mind that financial institutions are primarily concerned with the detection of unauthorized transactions (for which they may be held responsible). Typically, the bank or credit card network will contact the account holder to find out if he or she authorized a suspicious transaction. If the account holder can verify the transaction, there is likely to be no further verification (until another threshold is crossed, presumably).

### **Which Is the Greater Concern: Large-Value or Small-Value Transactions?**

The crucial question is as follows (and this question is probably unanswerable): How long could a group of persons use the electronic payment systems in this way, and how much money could they launder, before being detected? The issue for regulators concerned with the prevention of money laundering and terrorist financing is: which is the greater risk—that a few large-value, illicit transactions will occur or that a series of many small-value, illicit transactions will occur? In this regard, the key aspect of the electronic payment systems is that while large-value transactions may be effected more quickly, they are also more likely to be detected. That being the case, is illicit use of electronic systems more likely to occur in the form of a series of smaller transactions that, while taking more time, would be less likely to be noticed?

## Issues of Identify Verification

Considering the risk that electronic payment systems may be used to launder money also raises interesting questions about identity verification. First, it is important to note that identity verification serves different purposes in different contexts. For example, if an individual seeks to withdraw money from an account or to obtain credit, the financial institution is concerned with verifying that the person is who she says she is. Or, speaking more precisely, to verify that this individual is the same individual who controls the account or has a good credit record. On the other hand, if an individual seeks to open an account and deposit money, the bank has the opposite concern, that is, to establish that this individual is not one of the people listed on various watch lists, with whom the bank is prohibited from doing business.

Upon reflection, it is clear that the second situation raises more difficult issues of identity verification, whether the transaction is electronic or effected in person. In the first case, the individual has the burden of (and therefore has an interest in) proving that he or she is a particular person, in order to obtain the benefit of access to that person's accounts. But in the second case, all the bank has is a name on a list, and perhaps a few other details. So we face the difficulty of a person who has access to more than one identity, as criminals often do. If a criminal presents herself to a bank, in person, with a passport or other identifying documents that match her own physical characteristics, the bank will have difficulty "proving the negative," that is, establishing that the person does not have another identity currently on an identity watch list—no matter how diligent the bank is.

Current security controls are more effective in preventing criminals from assuming the identity of some other legitimate person in order to steal their money. That is, both the traditional, paper-based systems and the new electronic payment systems include means of preventing access to financial accounts by unauthorized persons. But in the second case—the money laundering and terrorist context—the person will assume a bogus identity and authorize transactions under that name, and the bank will never know that the person is actually someone who appears on a watch list.

For purposes of understanding the new electronic payment systems, the point is that they seem not to be any more vulnerable to the use of assumed identities for money laundering or other illegal activities than are the traditional systems. That is, it seems to be just as likely that bogus assumed identities could be used in the paper context as in the electronic context.

Finally, the particular concerns that the threat of terrorism raises for electronic payment systems should be noted. First, it must be noted that the system itself can be a target of terrorist attacks, because it is a part of the critical information infrastructure upon which the international financial system depends. The vulnerability to such an attack arises primarily from the fact that the closed proprietary networks used by financial institutions have to be open to the Internet in order to conduct business. This provides an access point to terrorists. Since it is impossible to prevent terrorist attacks completely, electronic payment systems must include measures to contain and remediate any security breaches.

### **Balancing Difficulties Arising in Electronic Payment Systems**

In conclusion, there are benefits and detriments in electronic payment systems in terms of the risk of money laundering and illegal activities. While it is true that electronic transactions can be effected more rapidly and from remote locations, it is also easier to maintain automatic records of such transactions or to put in place automated blockages of certain transactions. Similarly, while it is nearly impossible to verify the identity of someone who initiates a transaction remotely by electronic means, we must bear in mind that identity verification, in itself, raises a number of conceptual difficulties.



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## **VIII. BANK INSOLVENCY**

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**Deposit Insurance and Bank Insolvency  
in a Changing World: Synergies and  
Challenges**

MICHAEL H. KRIMMINGER

Today business and finance indisputably are global. The financial and capital markets are more globally integrated and move much more rapidly in response to events than ever before. As a result, many financial institutions and activities that once were local are now international. The changes in the international financial system have been driven by deregulation, by improvements in communications, by technological changes that have increased the speed and volume of transactions enormously, and by widespread innovation in markets, organizational structures, services, and instruments.<sup>1</sup> Often overlooked in the debate over globalization, however, is that smaller businesses and financial institutions participate in global trade and finance on an unprecedented scale. The interactions of businesses at all levels of the markets for goods, services, and financial assets affect the prices for goods, cost of capital, availability of credit, value of businesses, and economic efficiency of all countries.

While business and finance have been global in nature, most regulatory systems and laws have not followed suit. There are few international rules and norms to govern the linkages between financial institutions, payments systems, and markets. This is particularly true in banking and financial services. National laws define the relationships between domestic banks and between internationally active banks and other financial institutions. One crucial process that is almost exclusively governed by national law is the resolution of insolvent banks.

Effective insolvency rules, and the commercial infrastructure that they presuppose, are central to developing and maintaining the confidence of domestic, as well as foreign, businesses and investors. In some cases, national insolvency laws may not provide certainty to creditors or investors—even in local insolvencies. In other cases, the

laws may not be up to the task of coping with instability in the most important financial institutions.<sup>2</sup> In systems with deposit insurance, an effective insolvency system is vital to control risk taking and to ensure that financial assets remain productive. As a result, improving the effectiveness and efficiency of national insolvency systems is a crucial component of strengthening national and international financial systems. This chapter will review some of the developing standards for effective insolvency systems and offer examples from the U.S. system of specific laws reflecting these standards.

In today's global economy, even effective national insolvency laws cannot fully address the failure of an internationally active financial institution. Unfortunately, there are few internationally recognized insolvency rules. The absence of international rules and norms would not be overly troublesome if national insolvency laws were not inconsistent between countries. Differences in the treatment of secured creditors, rights to set-off and net, finality of transactions, and philosophical approaches to debtor-creditor relationships all increase the difficulties of responding to instability in larger, more complex banks with international operations. These inconsistencies are most important when they create uncertainty among other market participants and impair the ability of regulators and insolvency authorities to limit disruptions in key linkages between international financial firms. In this context, national laws and the few international rules may not fulfill the insolvency goals of reducing uncertainty, promoting efficiency, or providing equitable treatment to creditors. The second part of this chapter will review some of the current international rules and norms, and offer suggestions for future work.

These related issues suggest that efforts to strengthen insolvency laws and the international financial system should focus both on bolstering national insolvency laws and on enhancing the ability to respond to insolvencies affecting the cross-border linkages between financial institutions, payment systems, and markets. In recent years, regulators and bankers have undertaken significant steps to strengthen national regulatory and insolvency systems as well as these critical links. Many international groups, such as the Bank for International Settlements, the International Monetary Fund (IMF), the Group of Thirty, the World Bank, the Financial Stability Forum, and others, have worked to improve cooperation and to better understand the processes through which crises arise and are resolved. Cooperation

and coordination efforts by regulators have increased, both across sectors and across national boundaries. Further progress on these issues is fundamental to long-term economic stability.

## **Insolvency Principles**

### **General Goals of Insolvency Laws**

Recent analyses have identified a number of generally accepted principles for effective resolution of problem financial institutions. These principles are based on the normally complementary, but sometimes competing, goals of maximizing the value of the estate for the benefit of all creditors within an equitable, transparent, and predictable process while minimizing the cost of the resolution.<sup>3</sup> These goals follow from the function that insolvency rules fulfill in the national economic life, that is, returning financial assets to productive uses by mediating claims against insolvent companies or individuals. More broadly, these goals can be divided into three complementary components: reduction of legal and financial uncertainty, promotion of efficiency, and provision of fair and equitable treatment.<sup>4</sup>

Achieving these goals requires an effective and efficient legal and institutional infrastructure. The ability of any nation to provide greater certainty, efficiency, and fairness in an insolvency depends upon the environment provided by its laws, culture, markets, the availability of trained professionals (such as bankers, supervisors, lawyers, accountants, and others), governmental competence, and economic depth. For example, a functioning insolvency system must have well-designed insolvency laws, but it also must have laws that provide a basis for commercial activity, grant creditor and debtor rights, and otherwise promote predictable commercial outcomes. Beyond legal issues, the maturity of market mechanisms in a country will determine whether certain insolvency processes, such as auctions, bulk asset sales, or others, will be effective and maximize value by accessing a large enough pool of potential buyers. Such processes will also be affected by the reliability and transparency of prices and financial data, which themselves are dependent on the legal infrastructure and the presence of a trained cadre of financial and legal professionals. This does not mean, however, that all of these elements must, or should, exist to permit an effective insolvency system. It does indicate that the more a nation moves toward these mutually in-

terdependent features, the more likely that its insolvency system will be successful in providing certainty, efficiency, and equitable resolutions.<sup>5</sup>

### **Banking Insolvencies**

Insolvencies of banks and similar financial firms create additional problems. Due to the short-term liquidity of most banks' primary liabilities, banks are uniquely dependent on public trust for funding.<sup>6</sup> The largest banks have substituted the reliance on deposits for funding with market instruments. However, this simply has substituted reliance on depositor trust for reliance on market trust and, indeed, may have increased the risk of a liquidity collapse through a "market run." In short, a weakening large bank relying on the market for funding could find itself effectively excluded from the market by the increased costs of collateral and spreads. As commentators have noted, the resulting "market run" as counterparties liquidate contracts and impose additional costs on the weakening bank could increase the speed of its collapse.<sup>7</sup> It is a truism that the less time available for planning a resolution of a failing bank, the greater the potential losses and disruption. In such cases, the loss of confidence in one bank can have dire implications for confidence in the overall banking system.<sup>8</sup>

Another truism is that deposit insurance is designed, in part, to maintain public confidence in the banking system during times of institution-specific or broader systemic stress by reassuring depositors that their funds, or at least the insured maximum, will be protected even if their bank is closed. Deposit insurance thus exchanges the preexisting dynamic of depositor and market discipline, in part, for a regulatory buffer along with regulatory oversight. While insured banks remain reliant on public trust, that trust is supported, and perhaps supplanted to a degree, by public trust in the efficacy and reliability of the governmental promise of payment in an insolvency. Unless the supervisors are vigilant and disciplined, this substitution can allow weak and even insolvent banks to remain active and drain economic capital from more productive uses. An effective and fair insolvency system that quickly returns funds to depositors and retains credit in the market can ameliorate this bank-specific and external consequence. Deposit insurance without an effective insolvency system—that the supervisors use—can enhance moral hazard and impair economic efficiency. On the other hand, if the deposit insurer

does not or cannot fulfill the promise of payment within an acceptable time, then the short-term liability problem inherent in deposit-based banking will create recurring crises as depositor confidence ebbs and flows. Ultimately, the breach of this promise of payment will drain liquidity and resources from the financial system and reduce economic activity. Once again, the reduction of uncertainty is as important to deposit-based institutions as it is to market-based institutions.<sup>9</sup>

Whether dealing with a smaller, deposit-based bank or a larger, more market-based bank, the goals of an insolvency process must focus on promptly returning insured funds to depositors, maintaining critical bank functions, and ensuring public confidence in the equity of the resolution process. Speed is a fundamental element in an effective bank insolvency process. Returning cash to insured depositors quickly is as important as assurance of payment. Speed in taking over and continuing failing bank functions—whether payments processing, credit, or capital markets settling—limits the loss of value in the bank's assets, halts a potentially dangerous spread of settlement failures, and reduces the contagious loss of confidence in other banks.<sup>10</sup> However, speed must be matched by equity. Predictability and reliability of the process are essential if public and business confidence are to be maintained in the banking system.

### **Components of Effective Bank Insolvency Laws**

As noted by many international organizations and commentators, there are some common components of effective bank insolvency laws.<sup>11</sup> First, the overall legal infrastructure of the country must support the insolvency system. An important component of this legal infrastructure is effective and predictable commercial legal rules. A well-developed commercial law is a crucial prerequisite to functioning markets for goods, services, and financial assets as well as to a reliable business climate. An essential analog to the commercial law is an effective legal and institutional system for enforcing contracts and collateral foreclosure. Similarly, the legal infrastructure should support and enforce financial transparency, effective regulation, and the rule of law and provide independent courts and well-trained professionals. This legal infrastructure provides some of the preconditions for efficient markets and commercial stability, both of which



are important if the society is to be successful in recycling financial assets from insolvent companies.

Second, the laws must have clear criteria for initiating insolvency proceedings. This is particularly crucial in banking insolvencies in which otherwise insolvent banks may be able to continue indefinitely by raising funds from depositors and act as a drag or diversion of economic capital. Clear, mandatory criteria permit prompt and decisive action before the bank's equity is exhausted. The criteria should be mandatory to require supervisory action as capital or other indicia of institutional soundness erode. In effect, mandatory action requirements create the supervisory discipline that augments market discipline.

Third, the insolvency laws should provide that when a trustee or receiver is appointed it has immediate power to control, manage, marshal, and dispose of the bank's assets and liabilities. Many difficulties in resolving individual insolvencies, and in addressing broader instability, have been exacerbated by the inability of trustees or receivers to take prompt action while waiting for review or other preliminary action. If the public goal is preservation of funds and assets for repaying depositors, then a receiver needs flexibility and the ability to act quickly to maximize recoveries.

Next, the insolvency laws should confer adequate legal powers on the receiver that are sufficient to permit flexible and decisive action to maximize recoveries on assets and minimize delays in providing money back to depositors. These legal powers should include independence from undue interference by other governmental bodies, the ability to terminate contracts, the power to enforce contracts, the authority to sell assets, the right to avoid fraudulent or unauthorized transfers, and broad flexibility to design resolution and asset sales structures to achieve the goals of the resolution. A sometimes overlooked additional "power" that can be critical to encourage timely action to close a failing bank and to efficiently resolve it is immunity or indemnification for receivership or regulatory employees acting within the scope of their duties. Personal liability for lawsuits can bring regulatory and receivership action to a halt. Of course, the receivership or organizational entity should remain subject to suit to provide redress for real injuries.

Fifth, the insolvency laws should provide a transparent process for determination of claims against an insolvent bank. This will enhance public confidence in the process as well as provide mechanisms for the bank receiver to define the universe of claims pending against the failed bank. While often overlooked, the power to gather and define the claims against the assets of an insolvent institution is as important as the power to exercise ownership over those assets. As a result, well-defined time frames for filing claims after notice to potential claimants and rules barring late claims are important to allow the receiver to assess the return available to creditors. Related to this element are provisions designed to enhance the overall equity of the resolution process. For example, if some creditors receive preferential protection—or if some institutions receive preferential protection that extends to their equity holders—while depositors or other creditors at other institutions incur greater losses, it will damage public confidence. The Federal Deposit Insurance Corporation (FDIC) has, at times, been criticized for not providing equitable treatment across all receiverships—principally during the 1980s when some failing institutions received “open bank assistance” to avoid insolvency before enactment of the “least cost” requirement. An often cited example is Continental Illinois in 1984.<sup>12</sup>

Finally, this process should be designed to reimburse depositors up to the insured maximum as soon as possible, while minimizing the cost to the deposit insurance fund. While depositor confidence in the guarantee is based on the certainty of repayment, it is equally based on the speed of repayment. Unless depositors are confident that their funds will be available quickly, the risk of deposit runs on even solvent banks remains. A related part of the process must be an obligation to minimize the costs of the insolvency process. Even in a system without a deposit insurance fund, this requirement can be an important brake on the tendency to use an insolvency process to avoid recognition of losses through some broad or blanket guarantee. In some cases, the “easy” route of a blanket guarantee to mask infrastructural inadequacies and difficult policy choices has weakened the ability of the insolvency system to return assets to more productive uses and has undercut the credit culture of the financial system. A more limited guarantee, combined with explicit requirements to minimize losses in the resolution, promotes a well-funded insurance system as well as limits the moral hazard that can be engendered in a deposit insurance system. A well-funded insurance system also provides the ready cash

for quicker payment of insured deposits. Insolvencies and an equitable sharing of losses are valuable reminders that business, even banking, has risks and that creditors as well as supervisors must monitor the riskiness of the banks with which they do business.

While these insolvency principles are broadly applicable, the key elements of an effective insolvency system must be adjusted to conform to the existing financial, legal, institutional, and cultural conditions of the individual country. It would be the height of hubris, and folly, to suggest that the laws of one country should be rigidly applied in all other countries. While reflecting consistent and effective principles, laws must be adapted to respond to changed conditions or even the best legal rules will become ineffective. Moreover, even if the laws of one country could ever be said to have created a harmonious system of effective and complementary rules, those laws are inherently a product of that country's conditions. If those legal rules are inserted into another structural, financial, and economic environment, it is very unlikely that the rules would continue to be effective.

This is not to undercut the importance of recommended principles and laws. However, in applying those principles it is essential that they be implemented in a way that achieves the desired results in that particular country's environment.<sup>13</sup> For example, the virtually immediate access to insured deposits available following insured bank or thrift failures in the United States is only possible within a context of specific laws, effective supervision, reliable asset values, standard accounting procedures, and other related conditions. While a country will benefit greatly from improved public confidence and a reduced likelihood of bank runs if it can achieve a similar quick return of cash to insured depositors, it is unlikely to meet this goal without an infrastructure—beyond the insolvency law—that provides the foundation for expeditious resolutions.

Under U.S. law, insured bank and thrift resolutions are handled through a separate body of law principally found in the Federal Deposit Insurance Act, 12 U.S.C. §§ 1821–1825. By contrast, nonbank corporate insolvencies are addressed by the U.S. Bankruptcy Code, 11 U.S.C. §§ 101–1338. These different insolvency systems have many common features designed to systematize the management of the insolvency process and achieve an equitable disposition of the proceeds from the assets of the insolvent entity to its creditors. How-

ever, these systems also have significant differences that reflect the divergent policies that each seeks to achieve and the different characteristics of the entities they are responsible for resolving.

## **Elements of the U.S. Bank Insolvency Laws**

Some of the key elements of a national insolvency system of laws for banking insolvencies can be illustrated by the American laws governing failing banks and thrifts.

### ***Clear Criteria for Initiating Insolvency Proceedings***

The Federal Deposit Insurance Act contains a number of grounds for the closing of an insured bank or thrift. Those include capital-based as well as liquidity, illegality, and other soundness criteria.<sup>14</sup> The most explicit and most used bases for closing U.S. banks and thrifts are the capital-based grounds under “prompt corrective action” (PCA). Adopted in 1991 as part of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), PCA prescribes mandatory measures for undercapitalized institutions.<sup>15</sup> As an institution’s capital declines, additional supervisory controls may be imposed in an effort to stem the erosion of its capital position. However, once an institution’s tangible capital is equal to or less than 2 percent of total assets, it is defined as “critically undercapitalized.” Once the institution is defined as “critically undercapitalized,” a conservator or receiver must be appointed within 90 days unless the institution can improve its capital ratio or the period is extended. The appropriate federal regulatory authority can grant up to two 90-day extensions of the PCA period if it determines that those extensions would better protect the relevant insurance fund from long-term losses. A firm cutoff point, such as prompt corrective action, along with a role for the deposit insurer promotes effective resolutions and also provides a prod for enhanced efforts by management to recapitalize or correct problems to save a weakened bank.

A firm deadline for closing a failing institution also facilitates a critical element in the FDIC’s ability to return funds to depositors virtually overnight in most cases. That element is the opportunity to develop detailed information about a failing bank or thrift during the 90-day period between a notice that the bank is critically undercapitalized and the PCA deadline. Through close cooperation with the

primary chartering authority or regulator (such as the state banking authority, the Office of the Comptroller of the Currency (for national banks), the Office of Thrift Supervision (for federal thrifts), and the Federal Reserve) and the FDIC's own supervision department, the resolution staff can access financial information, share that information with potential bidding institutions under a confidentiality agreement, solicit bids, and select a successful bidder before the institution closes. U.S. regulators have learned that it is essential to have early access to reliable information. This allows the regulator to select and design more suitable failed bank resolution and asset disposition structures. Reliable information also serves to attract more potential purchasers and to reduce resolution costs by minimizing the "risk premium" required by potential investors.

### ***Immediate Vesting of Full Control/Ownership of Assets and Liabilities in the Independent Insolvency Authority***

Under the Federal Deposit Insurance (FDI) Act, the FDIC has complete power over the assets and liabilities of the failed bank or thrift as soon as the FDIC is appointed as receiver.<sup>16</sup> This power allows the receiver for a failed bank to arrange an immediate sale of assets and transfer of insured deposits to another bank. Such immediate sales limit the impact of the failure on depositors, borrowers, and economic activity. In addition, the FDIC has found the prompt resolution and sale of assets reduces the losses to the deposit insurance funds.<sup>17</sup>

Since the receiver for a failed bank is immediately vested with full ownership over the assets, it can complete a sale as part of the initial resolution, or shortly thereafter, without awaiting court, creditor, or shareholder approval. This is an important power and facilitates greater reliance on market-based valuations and sales techniques. Today, the FDIC uses technology to make failing bank asset information available to potential purchasers through certificates of deposit and secure Internet sites.

### ***Effective and Flexible Legal Powers***

The FDIC, when acting as conservator or receiver for a failing bank or thrift, has been granted broad legal powers that help achieve quick resolution of failures by limiting shareholder participation, con-

trolling assets and claims, and promoting decisive action. The policy goal underlying these powers is to provide the bank receiver with flexibility in maximizing recoveries to the benefit of the bank's creditors and the deposit insurance funds. Statutory flexibility may be crucial to adapt to changing circumstances in insolvencies. A brief discussion of these powers will highlight the policy choices that have been made in the United States.

The FDIC's receivership powers reflect a policy choice that limiting losses to the deposit insurance funds and depositors is more important than protecting equity holders or other creditors. First, the FDIC as receiver cannot be ordered to take or refrain from taking specific action by a court or any other governmental agency.<sup>18</sup> The receiver is not immune from court action, but any remedy is limited to money damages. An important component of the resulting freedom of action is that FDIC employees generally are not personally liable for the actions of the receiver. Any claims for damages normally are limited to actions against the receivership or the FDIC. This legal independence is crucial in allowing quick sales of assets by preventing shareholders or other parties from halting receivership activities. Second, agreements with the failed bank are unenforceable unless they comply with statutory requirements mandating that written documentation be contained in the bank's records and approved by senior management of the bank.<sup>19</sup> Thus, any unwritten side agreements affecting the bank's assets are unenforceable. Third, claims against the bank are limited to those that existed at the time the bank failed. As a result, claims based on future events are barred.<sup>20</sup> Fourth, the receiver has the common law and statutory power to repudiate or disaffirm contracts that may be burdensome.<sup>21</sup> Finally, although in contrast to U.S. Bankruptcy Code proceedings, there is no automatic stay upon appointment of a receiver for a failed bank, some provisions, in effect, impose a moratorium on adverse action by creditors or debtors after appointment of the FDIC as a conservator or a receiver. For example, a contract party cannot terminate, accelerate, declare in default, or exercise any other contract rights based upon the insolvency or the appointment of a conservator or receiver.<sup>22</sup> This provision allows the receiver to enforce contracts that may be necessary or valuable to the receivership. However, termination and netting rights under certain types of financial contracts, such as swaps and similar agreements, can be exercised.<sup>23</sup> In addition, if a lawsuit is pending against the failing bank when a conservator or receiver is appointed,

the other party cannot proceed with the lawsuit until after it exhausts a statutory receivership claims process.<sup>24</sup> This permits the receiver to stay lawsuits and bar new lawsuits until an administrative claims process is completed.

### ***Equitable Process for Determining Claims***

An essential part of effective government is maintenance of public confidence in the fairness of government. Effective insolvency laws must include a fair process to determine claims. In the U.S. system, the receivership claims process offers the receiver an opportunity to determine claims against the failed bank or thrift and, if dissatisfied with the result, it offers the claimant unfettered access to the courts. The receivership process includes well-defined time frames for notice to potential claimants and for filing claims (which if violated bar the claim), for decisions on claims, and for notification to claimants of a decision. The statutory procedures also specify the time period within which a claimant must file a court action to pursue the claim before an independent tribunal. As noted above, this also applies to claims pending in court before the bank or thrift was closed. Those preexisting lawsuits must be stayed until the receivership process is completed.<sup>25</sup>

### ***Prompt Payment to Depositors While Minimizing Costs***

In addition to these statutory powers, several factors affect the ability of a deposit insurer to make prompt payment to depositors. These include adequate funding, the availability of accurate and complete information for pre-planning, and transparency of financial records.<sup>26</sup>

In the United States, funding for payment of depositors is provided through deposit insurance funds managed by the FDIC and maintained through risk-based assessments on open depository institutions.<sup>27</sup> The resilience of the deposit insurance funds is supported by a national statutory priority for depositors and by the “least costly” test. Once it provides protection for insured depositors in a failed institution, the deposit insurance funds become subrogated to claims of the insured depositors and recover along with uninsured depositors through depositor preference.<sup>28</sup> As noted above, a fundamental part of prompt payment of depositors is the ability

offered by the PCA standards to obtain, use, and share confidential information about a failing bank or thrift in advance of its closure. Laws that too tightly restrict access to such information in some countries, under bank secrecy or privacy laws, can seriously impair the ability to quickly return funds to insured depositors. Financial transparency and the ability to rely on accounting and banking records are necessary for depositor protection. In the United States, bank examinations and audit standards support oversight of bank accounting and help identify troubled institutions. It is no coincidence that the biggest proportionate losses to the deposit insurance funds have occurred when financial transparency did not exist. In its absence, depositor protection and the efficient sale of banking assets that supports it will be seriously compromised.

A final component of the U.S. system for resolving failing banks and thrifts is the requirement that, absent a systemic crisis, the FDIC must choose the resolution structure that is “least costly” to the deposit insurance funds “of all possible methods.”<sup>29</sup> U.S. law also prohibits using the insurance funds in a fashion that benefits shareholders. While this requirement clearly limits the flexibility accorded to the FDIC, it serves as a control on expenditure of deposit insurance funds and delays in recognition of losses on nonperforming assets. This requirement also prevents reliance on blanket guarantees or other resolutions that protect uninsured depositors or other creditors. Prior to 1991, the United States used a less stringent control on losses that required only that the resolution method be “less costly” than a liquidation and direct payment of insured depositor claims. The “least costly” requirement reflects the U.S. policy choice to control costs and protect the viability of the pre-funded deposit insurance funds.

The U.S. system also includes a provision permitting an exception to the “least costly” requirement only if the “least costly” resolution “would have serious adverse effects on economic conditions or financial stability” and an alternative resolution “would avoid or mitigate such adverse effects.” The determination that the “least costly” resolution would have such consequences must be made by the Secretary of the Treasury, in consultation with the President, upon the recommendation of two-thirds of the votes of the FDIC Board of Directors and the Board of Governors of the Federal Reserve System. This is commonly referred to as a systemic risk determination.<sup>30</sup> The



restrictions on this exception to the “least costly” requirement highlight the U.S. policy to avoid moral hazard and protect the deposit insurance funds against additional expenditures.

In the United States, these laws were implemented over an extended period of time, but were responses to specific periods of banking crises—principally the Great Depression and the banking and thrift crisis of the late 1980s and early 1990s. Many of the most recent and important changes to bank insolvency laws have never been tested during a banking crisis because they were adopted as the last U.S. banking crisis began to ebb. For example, prompt corrective action and the “least costly” requirement were adopted in 1991—after the frequency of failures had begun to decline. While these are undoubtedly important innovations that have worked well during the intervening years, they have not been tested during a crisis. National laws must adapt to changed circumstances and, it must be presumed, U.S. laws may be modified in the future to further improve their effectiveness in achieving the goals of the bank insolvency system. Nonetheless, the current provisions incorporate key elements recommended for effective insolvency legal systems.

### **Current International Insolvency Structures**

Effective national insolvency laws are a fundamental element in addressing cross-border insolvencies. Effective national laws are not enough. However, there are few standard international rules to govern the failure of financial firms and banks, and current national rules create a significant potential for conflicts.<sup>31</sup> The few international rules that exist tend to address insolvency rules within defined geographical or economic relationships, such as the European Union’s Insolvency Regulation.<sup>32</sup> Even these few rules address primarily judicial and regulatory cooperation and not the substance of the law governing an insolvency. While this state of international insolvency law is appropriate for addressing stable “hard” assets and enterprises, it may not provide the combination of certainty and flexibility necessary to avoid possible contagion effects in rapidly changing markets and payments processes.

One of the most vital issues in the insolvency of an internationally active financial firm is to avoid disruption in key interbank link-

ages, such as the settlement of obligations, capital markets, clearing and settlement systems, and correspondent banking services.<sup>33</sup> A significant complicating factor is that the national legal rules and policy choices that govern the resolution of international financial institutions may conflict and, at a minimum, may preclude effective action at the time of insolvency. There are several interrelated issues. First, there is no international insolvency standard for banks or other financial institutions. While it may be appropriate that different nations—with different economic and cultural histories—have adopted varying laws and policy choices to govern domestic financial insolvencies, it is essential that the basic legal mechanisms applicable to key international linkages permit effective action to mitigate contagion effects around the globe. Second, current laws around the globe do not adequately address the complexities created by international holding company structures. These complex structures certainly create difficulties in regulatory coordination under normal conditions. During a period of financial instability, the differing regulatory jurisdictions within a nation and between nations create even more difficult challenges in pre-failure coordination. International supervisors are taking steps to improve understanding and coordination before insolvency. However, if insolvency occurs, the different legal rules and policies that apply to banking, insurance, and securities components of a holding company structure could impair the ability to respond effectively to prevent cross-border crises. Current insolvency laws may not provide the level of flexibility available to regulators once the actual insolvency occurs. Third, in a world of 24/7 financial operations and markets, the many legal rules that are based on the pace of the nineteenth or even twentieth century may not be up to the task. It is essential that insolvency rules give decision makers the flexibility and authority to take action in “real time” to avoid compounding the effect of a single large insolvency through the linkages between markets and payments systems.

What sources exist today for rules to govern a cross-border insolvency? These can be grouped into (1) national law, (2) multinational agreements to facilitate international cooperation, (3) private international norms, (4) the United Nations Commission on International Trade Law (UNCITRAL) Model Law, and (5) the European Union approach. All of these initiatives seek to provide a basis for cooperation in legal insolvency proceedings. These initiatives enhance the ability of insolvency authorities to cooperate and coordinate their ac-

tions.<sup>34</sup> This cooperation and coordination may be vital to limit disruption in a crisis. However, most do not address the substantive rules that govern the payments systems and other key links.

### **National Law**

The foundation of international insolvency law remains national law. Each country has developed general insolvency laws to deal with the failure of most enterprises. Countries also have developed either special provisions within the general insolvency law to deal with special types of debtors, such as banks, or special insolvency legal systems to deal with those special debtors. In all of these cases, however, the operative substantive and, for most issues, procedural law is the law within one country.

To the extent that national laws address how to deal with debtors, creditors, assets, and liabilities outside the national boundaries, these laws adopt one of two basic positions: territorialism or universalism. Different laws, of course, may adopt any number of permutations of these positions, but the basic premises of those laws remains either focused on resolving the insolvency within a single nation or on resolving the entirety of the insolvency on an international basis. Under a territorial approach each country adjudicates claims against the assets within its borders for the benefit of creditors of the insolvent local firm with little or no regard for foreign proceedings. This approach focuses on the primacy of national law within the territory of the country. The law where the assets are found thus controls their distribution. A universal approach, on the other hand, allows a single jurisdiction to adjudicate the worldwide claims against the debtor and its worldwide assets with the cooperation of courts or other authorities in each affected country. This approach effectively applies national law to all worldwide assets and claims. Typically the claim to jurisdiction is based on the focus or center of the firm's operations residing in that jurisdiction and acquiescence in the fairness of the proceedings by other courts.<sup>35</sup> The universal approach can achieve an equitable distribution of the proceeds from the failed firm's assets to all worldwide creditors.

Most nations currently apply a territorial approach to cross-border insolvencies. This simply is a consequence of the domestic focus of most insolvency laws. To the extent that national insolvency laws

address cross-border issues, most nations permit cooperation with foreign insolvency authorities within constraints imposed by the national insolvency policies. National insolvency laws typically address recognition of foreign proceedings, recognition of foreign representatives, and the participation of foreign creditors in domestic proceedings. National insolvency laws vary considerably in how they deal with these “relationship” issues, and equally in how they treat different classes of creditors.<sup>36</sup>

Cooperation between national insolvency authorities under national law typically works reasonably well. To the extent that the separate national substantive provisions create inequities, normally there are limited effects on other businesses. However, if the separate substantive rules prevent settlements or impair market functioning for a major internationally active financial firm, the statutory inconsistencies could increase the risks of transnational contagion. Harmonization of national insolvency laws may not be required to avoid this risk. Indeed, both territoriality and universality are based on sound policy grounds. However, it may be vital in a crisis for nations and the international community to have the statutory and structural infrastructure to permit flexible and timely action to prevent or ameliorate disruption in the key linkages between markets and transnational financial institutions.

What, then, are some of the current multinational avenues to limit disruption?

### **Multinational Agreements**

Some older efforts to address cross-border insolvency issues within treaties or multinational conventions represented advances in cooperation, but were limited in their geographic and substantive scope. The Convention on Private International Law, more commonly referred to as the Havana Convention, is a 1928 agreement between a number of Central and South American nations to deal with the cross-border effects of insolvencies. The Havana Convention provides for separate and parallel insolvency proceedings when the debtor has more than one business location. On the other hand, when the debtor is located in a single nation the Convention authorizes broad powers for that nation’s authorities to collect assets, manage operations, and enforce judgments in the territories of the other signatory countries.

While the Havana Convention still leaves many judicial cooperation and substantive law issues unresolved, it was a major change from the pure territoriality of national laws. Another example is the Convention Regarding Bankruptcy, commonly known as the Nordic Convention. In this 1933 agreement, the five Nordic countries focused on the principle of providing extraterritorial effect to judgments by the home country court. As a result, the judgment of a Norwegian home country court on assets in Iceland must be given effect in Iceland on key issues, such as the priorities for distribution of assets. However, there are limits to the extraterritorial effect of the home country courts. For example, collection on claims in other countries under the Nordic Convention is based on the law where the asset is located, not the home country's law. Both the Havana Convention and the Nordic Convention represent one option for addressing the conflict among national laws within geographic limitations.<sup>37</sup>

### **Private International Norms**

Recently, there have been several private efforts to improve cooperation in cross-border insolvencies. First, private groups have developed nonstatutory principles to govern international insolvency issues. The two principal examples are the Cross-Border Insolvency Concordat, which was approved by the Council of the Section on Business Law of the International Bar Association (IBA) in September 1995 (the Cross-Border Insolvency Concordat) and the American Law Institute's Principles of Cooperation in Transnational Insolvency Cases Among the Members of the North American Free Trade Agreement (ALI Principles). Both the IBA's Cross-Border Insolvency Concordat and the ALI Principles seek to establish norms to harmonize separate national insolvency proceedings involving an internationally active debtor. These norms do not propose changes to national laws.

The IBA's Cross-Border Insolvency Concordat includes general principles to define the interaction between lawyers and national authorities. The principles, rather than defining the parameters of the insolvency, seek to serve as a road map for insolvency attorneys and courts that could be implemented by judicial decision or the agreement of creditors' groups.<sup>38</sup> The principles include coordination of all insolvency proceedings for a cross-border insolvency in a single forum, the right of creditors and administrators in other forums to ap-

pear in any relevant forum, distribution of assets in all forums pro rata among creditors of the same class, and substantive rules being applied based on the applicability of that substantive law to the parties or assets involved.<sup>39</sup> The principles attempt to ease the effects of the inconsistencies between national laws through comity between authorities while recognizing the continued application of national law.

Like the Cross-Border Insolvency Concordat, the ALI Principles are a private sector initiative to develop principles and mechanisms to enhance cooperation for multinational bankruptcy cases. The ALI Principles focus specifically on cross-border insolvencies within the area subject to the North American Free Trade Agreement (NAFTA). This initiative created an accepted statement of the insolvency laws of the three NAFTA countries, Canada, Mexico, and the United States, and, using this as a basis, developed seven principles—to be implemented by the parties to insolvency cases, courts, and trustees—to achieve timely communication and cooperation.<sup>40</sup> Those principles are (1) cooperation; (2) recognition of proceedings and administrators in other NAFTA countries; (3) implementation of a stay in each country where the debtor has assets; (4) free exchanges of information among proceedings; (5) after recognition, distribution of assets on a transnational basis; (6) rejection of discrimination based on nationality, domicile, or residence; and (7) prevention of distributions in multiple countries that would permit creditors to recover more than that received by creditors of the same class in that country. These principles are accompanied by “procedural principles” to assist parties and courts in applying the basic principles and “guidelines” for court-to-court communications. For example, the principle on stays is accompanied by procedural principles to guide courts in reconciling stays in different countries and in applying stays. As a result, the ALI Principles seek to create a common language of insolvency among the NAFTA practitioners and to establish guidelines within this common language to promote cross-border cooperation and predictability.

A second effort has again been one by the private sector, supported by statutory changes under national laws, to develop private contractual solutions to potential transnational insolvency disputes. One of the most significant efforts has involved the development of standardized documents to permit termination and closeout netting of

certain financial contracts, such as swaps and repurchase agreements, and, crucially, the extension of this effort to achieve statutory changes to permit enforcement of those contractual rights in insolvency proceedings. Initially as a reaction to the uncertainty created by settlement mismatches and potential delays in market-sensitive financial contracts, financial firms and their lawyers developed master agreements under which individual transactions can be regulated by identical contract terms. To be effective, however, these agreements must be enforceable under national insolvency laws, which typically bar termination, netting, and set-off of claims after initiation of the insolvency proceedings. Through international lobbying efforts and with the active support of financial regulators, the securities and derivatives industry has been successful in gaining legal protection for these contractual provisions in virtually all nations with active participation in the financial markets.<sup>41</sup> Financial regulators have been active participants in this endeavor because of the concern that settlement mismatches or stays of contract termination and netting could create a domino effect in other financial firms and in markets throughout the world. Standardized agreements now exist for several types of transactions. Two important examples are the International Foreign Exchange Master Agreement and the International Swaps and Derivatives Association Master Agreement.

### **The UNCITRAL Model Law**

In 1997, the United Nations Commission on International Trade Law issued its Model Law on Cross-Border Insolvency. As its name suggests, the UNCITRAL Model Law is a model law for adoption by individual countries that specifies mechanisms for coordination between courts in cross-border insolvency cases in order to reduce the potential for competing and inconsistent decisions on the assets and liabilities of the debtor. The UNCITRAL Model Law applies to all insolvent firms, but it does include optional provisions to allow a country to exclude certain companies, such as banks and insurers, from its coverage.

The Model Law does not address the substantive law applicable to key transactions or assets, but leaves those issues to individual national laws. The UNCITRAL Model Law focuses on (1) access to courts by foreign country insolvency administrators, (2) defining when a foreign country insolvency proceeding will be “recognized”

and the benefits of “recognition,” (3) clarifying the rules for cooperation by national courts with foreign insolvency proceedings and administrators, (4) specifying procedures for coordination between concurrent insolvency proceedings, and (5) providing rules to coordinate the relief available to creditors by providing foreign creditors with notice and access to local insolvency proceedings. The Model Law includes a process for obtaining recognition of a foreign proceeding. If a foreign proceeding is recognized as a “main” proceeding a stay is imposed on actions against the assets of the debtor, the transfer of such assets, and execution against the debtor’s assets. These rules help support the coordination goals of the Model Law by focusing resolution efforts into the “main” proceeding. The Model Law additionally provides for coordination of concurrent insolvency proceedings in multiple jurisdictions.<sup>42</sup>

In short, the Model Law is an important step to developing a common legal infrastructure for close cooperation between judicial authorities and recognition of the enforceability of foreign court rulings. At this date, it has not been adopted by most developed countries, although it has been adopted by Japan, Mexico, Poland, Romania, and South Africa.

### **The European Union Approach**

The European Union’s recent insolvency regulations represent new, statutory efforts to create a common “universal” approach to cross-border insolvencies within a unifying political entity. The resolution of failed banks is addressed by EU Directive 2001/24/EC of April 4, 2001 on the reorganization and winding up of credit institutions. In short, the EU’s Insolvency Regulation seeks to establish an EU-wide insolvency process providing for nondiscrimination and equal treatment of creditors, recognition of other EU insolvency proceedings, and cooperation among insolvency authorities as an overlay on national insolvency law. The Insolvency Regulation does not displace substantive law, but provides an infrastructure for mediating potential conflicts among jurisdictions that could assert primary control by conferring plenary authority on the “home member state.” The “home member state” is the original chartering or incorporating authority for the insolvency firm. This state has exclusive jurisdiction to decide to open “reorganization measures” and “winding-up proceedings” and its substantive law governs critical legal issues, such as de-



termination of claims, assets covered by the proceedings, conditions for set-off, and effects of the proceedings on current contracts. The decisions of the “home member state” on these and other issues are recognized and fully effective in other EU states.<sup>43</sup>

The Insolvency Regulation includes provisions to address cases where a blanket application of the “home member state” may be inappropriate, such as netting agreements that are governed by the law specified in the netting contract.<sup>44</sup> A separate directive, EU Directive 98/26/EC of May 19, 1998 on settlement finality in payment and securities settlement systems, also accommodates netting contracts by allowing the contracting parties to determine which law will apply and by ensuring that netting is enforceable despite an event of insolvency. These provisions offer additional certainty for critical linkages between markets and internationally active firms. Similarly, this “Settlement Directive” provides that insolvency proceedings will not have retroactive effect to impair settlement of obligations in a payment system.<sup>45</sup> This addresses the so-called “zero hour” issue for settlement finality in an insolvency.

For insolvencies among EU members, the Insolvency Regulation embodies the universal approach by treating the entire bank and its branches as a single entity subject to resolution under the law of the “home member state.” Even within the European Union there remains the possibility for conflict because countries can, and have, exercised the option to opt out of the Insolvency Regulation. However, if the insolvency involves a debtor, creditors, and assets located outside the European Union, the territoriality approach typically used under members’ national laws will be applied because the Insolvency Regulation confines its scope to insolvencies within the European Union. Article 1(2) of the Insolvency Regulation specifies that it will apply to a non-EU credit institution only if the institution has branches in at least two EU member states. Even in those cases, separate substantive law will apply in separate insolvency proceedings administered by the EU host countries. As a result, universality will apply among the EU member states, but not for the resolution of the foreign bank as a whole.<sup>46</sup>

The Insolvency Regulation certainly goes beyond the UNCITRAL Model Law because the Insolvency Regulation identifies the governing substantive law and provides for greater enforceable

decisions by the “home member state.” As such, the Insolvency Regulation and other EU Directives provide a more complete harmony of substantive law.

This survey of current international insolvency rules reveals the limitations and strengths of a reliance on national law with coordinating international conventions. The question remains whether the current international rules are adequate to provide certainty while offering insolvency authorities the flexibility to respond to an emerging crisis.

### **Conclusions and Next Steps**

Deposit insurance can be a significant part of a stable, efficient national financial system. An equal partner in such a financial system is an effective system to deal with the inevitable insolvencies in a free-market economy. An effective insolvency system can be judged by its ability to reduce uncertainty, promote economic efficiency, and provide fair and equitable treatment to creditors. National insolvency systems are making great strides in meeting these goals. International organizations, such as the International Monetary Fund, private groups, and governmental agencies are assisting nations in their efforts to reform insolvency and related infrastructures to allow full participation in the international marketplace.

With increasing integration of all nations into the global economy, the national and international insolvency rules have become central to risk management and stability. Unfortunately, as the foregoing survey of international insolvency approaches and insolvency structures demonstrates, the current international rules for insolvency probably do not satisfy the developing international standards for an effective system. The current approach to cross-border insolvencies is typified by procedural mechanisms to encourage international cooperation within a controlling framework of national law. While recent efforts have achieved substantial improvements in the ability of regulators and insolvency tribunals and authorities to coordinate their efforts, further steps are necessary.

These steps probably should not include substantive uniformity among national laws. National laws are based on philosophical and

policy choices that each nation has made about the goals and outcomes appropriate in an insolvency. Similarly, those steps also probably should not include a global adoption of a universal approach to cross-border insolvencies. Territoriality and universality each proceed from sound principles and policy choices. Any solution to this challenge must proceed from practical and not from theoretical or political positions.

What could these practical steps include? Policymakers and astute observers of the past and potential future problems in cross-border insolvencies surely will have many specific recommendations. One important next step may be to identify and focus on the critical linkages through which financial instability could spread to other markets or institutions. Some of those key linkages are the payments systems, certain capital markets, individual clearing systems and financial firms who fulfill critical clearing and settlement functions, and some correspondent banking relationships. All of these critical linkages are interrelated, and in many instances it is difficult to differentiate the processes and links forged between financial institutions in these areas. Nonetheless, it is useful to distinguish between these linkages because this focuses attention on how different elements of the interwoven fabric of interfirm ties each could give rise to contagion. For example, while correspondent banking services are part of the payments systems, the importance of those services to smaller firms that could result in a spread of large bank risk throughout the economy can be submerged in analyses focusing on the causes and spread of instability solely among larger banks.

While much progress has been made, specific, additional steps to improve harmonization of the contractual infrastructure underlying these linkages should remain a focus to ensure that they remain functional in an insolvency of a key member. An example of ongoing work is ensuring that key contracts for customers, vendors, and participants are enforceable in all relevant jurisdictions irrespective of the insolvency of any one of those parties. As noted above, one success story in the development of such contractual rules, and supporting statutes, is the netting provisions common in many financial contracts today. It was only a few years ago that closeout netting of financial contracts was ill protected and even broadly viewed as a breach of the theoretical underpinnings of insolvency law. Nonetheless, the logic of preventing contagion effects from the insolvency of

a single market participant and the importance of maintaining liquidity in rapidly moving markets led to the relatively quick adoption of insolvency laws that protected contractual netting after a declaration of insolvency.

Statutory rules also must ensure that regulators and insolvency authorities can cooperate to control risks. While insolvency laws inherently control risks and allocate losses, normal insolvency laws may not do so as quickly as is necessary. Most critically, the legal rules governing how we restructure a financial organization and continue to complete payments and other critical functions must occur in “real time” if the critical linkages are to be maintained and systemic effects avoided. A likely prerequisite for “real-time” legal rules is greater harmonization in the cross-border and cross-industry rules that determine what business processes can continue, settle, and be completed despite the declaration of insolvency. Similarly, the differing treatments of banks compared to other corporate debtors and the “first-to-file” effects of initiating an insolvency in one jurisdiction over others can create potential disruptions in operations and inconsistencies in the impact on creditors.<sup>47</sup> Initiatives such as the UNICITRAL Model Law and others will help resolve some of the cooperation issues. While national rules should continue to govern most substantive areas in an insolvency, it may be necessary to look to an international standard, enacted in national laws as was done with netting protections, to ensure continuation of key functions and greater flexibility for regulators and insolvency authorities. Some nations have a great deal of flexibility in some areas, while remaining limited in others.

The future of deposit insurance and the public confidence and stability it was designed to achieve may rest on our ability to adapt to a globalized world of finance. A key step is continuing improvements in national bank insolvency laws. The most difficult steps may be in adapting national laws to the global scope of enterprise.

## Notes

<sup>1</sup> Lawrence J. White, “Technological Change, Financial Innovation, and Financial Regulation in the U.S.: The Challenges for Public Policy,” Stern School of Business, New York University (August 1996); “Banking Is Becoming a Less Local Business,” *The Economist* (April 17, 2004).

<sup>2</sup> The discretion conferred on many central banks to provide liquidity to systemically significant banks generally does not extend to systemically significant nonbanking institutions. Nor is there a mechanism for coordinated assistance of this kind for a global institution with sizable operations in a number of jurisdictions. Nonbanks may pose as great a threat to the global financial system as our largest banks, yet the mechanisms under insolvency law to permit a system-focused resolution rather than a creditor-focused resolution may not exist. See Michael Krimminger, “Insolvency in the Financial Markets: Banks, Hedge Funds, and Other Complications,” 18(4) *Banking Policy Report*, at 4 (January 18, 1999).

<sup>3</sup> See John F. Bovenzi, “Resolving Large Complex Financial Organizations,” comments delivered at the 38th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 10, 2002; Group of 10 (G-10) Contact Group on the Legal and Institutional Underpinnings of the International Financial System, “Insolvency Arrangements and Contract Enforceability” (September 2002); Bethany Blowers, “The Economics of Insolvency Law: Conference Summary,” *Financial Stability Review* of the Bank of England, at 154 (December 2002); IMF Legal Department, *Orderly and Effective Insolvency Procedures* (Washington: IMF, 1999); Stijn Claessens, “Experiences of Resolution of Banking Crises,” prepared for joint PBOC/BIS Seminar on Strengthening the Banking System in China, February 28–March 2, 1990, at 280–83 (Washington: IMF, 1990); see also Bank for International Settlements, “Report of the Working Group on International Financial Crises,” Appendix A (October 1998) (defined as applying solely to commercial firms).

<sup>4</sup> See Rosalind L. Bennett, “Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers,” 14(1) *FDIC Banking Review*, at 3–7 (Fall 2001); G-10 Contact Group on the Legal and Institutional Underpinnings of the International Financial System, “Insolvency Arrangements and Contract Enforceability,” at i (September 2002).

<sup>5</sup> See, e.g., G-10 Contact Group on the Legal and Institutional Underpinnings of the International Financial System, “Insolvency Arrangements and Contract Enforceability,” at Appendix A (September 2002); Global Bank Insolvency Initiative, “Legal, Institutional, and Regulatory Framework to Deal with Insolvent Banks” (March 2004); Financial Stability Forum,

“Guidance for Developing Effective Deposit Insurance Systems,” at 12 (September 2001); Subhrendu Chatterji, “Bank Restructuring and Recapitalization: The Key Issues,” Financial Sector Chapter of the U.K. Department for International Development’s *Guide for Economists*, at 3 (January 1999).

<sup>6</sup> See speech by David Clementi, Deputy Governor of the Bank of England, London, July 19, 2001, at 3, <http://www.bis.org>.

<sup>7</sup> G-10, “Report on Consolidation in the Financial Sector,” at 15 (January 2001).

<sup>8</sup> See Aristobulo de Juan, “Does Bank Insolvency Matter? And What to Do About It?” in P. Collier, eds., *Financial Systems and Development in Africa*, EDI Seminar Series (Washington: World Bank, 1991).

<sup>9</sup> See Andrea Maechler and Kathleen McDill, “Dynamic Depositor Discipline in U.S. Banks,” FDIC Working Paper 2003-7 (November 2003); Global Bank Insolvency Initiative, “Legal, Institutional, and Regulatory Framework to Deal with Insolvent Banks” (March 2004); Financial Stability Forum, “Guidance for Developing Effective Deposit Insurance Systems,” at 8–11 (September 2001).

<sup>10</sup> See Chatterji, *supra* note 5, at 5.

<sup>11</sup> See G-10 Contact Group on the Legal and Institutional Underpinnings of the International Financial System, “Insolvency Arrangements and Contract Enforceability” (September 2002); Global Bank Insolvency Initiative, “Legal, Institutional, and Regulatory Framework to Deal with Insolvent Banks” (March 2004); Financial Stability Forum, “Guidance for Developing Effective Deposit Insurance Systems,” at 8–11 (September 2001); IMF Legal Department, *Orderly and Effective Insolvency Procedures* (Washington: IMF, 1999).

<sup>12</sup> See FDIC, *Managing the Crisis: The FDIC and RTC Experience 1980–1994*, at 545–65 (August 1998).

<sup>13</sup> See de Juan, *supra* note 8.

<sup>14</sup> 12 U.S.C. § 1821(c)(5).

<sup>15</sup> FDICIA required federal regulators to establish five capital levels ranging from “well-capitalized” to “critically undercapitalized.” These levels serve as the basis for PCA and, as the capital level declines, the regulators can impose increasingly stringent controls on the institution. Those controls may include limits on deposit taking and other business restrictions. 12 U.S.C. § 1831o(b)(1).

<sup>16</sup> 12 U.S.C. § 1821(d)(2).

<sup>17</sup> Unnecessary delays only serve to reduce asset values and to increase resolution costs. Reasons for this loss in value (called the “liquidation value”) include (1) information costs incurred by prospective purchasers; (2) disruption in financing for partially completed projects; (3) reluctance of receivers to grant additional financing; (4) borrower’s incentives to negotiate reduced payments with receivers; and (5) the administrative costs of the receivership. See FDIC, *Resolutions Handbook: Methods for Resolving Troubled Financial Institutions in the United States*, at 21–22 (1998).

<sup>18</sup> 12 U.S.C. § 1821(j).

<sup>19</sup> 12 U.S.C. § 1823(e); see *Langley v. FDIC*, 484 U.S. 86 (1987).

<sup>20</sup> 12 U.S.C. § 1821(e)(3)(A).

<sup>21</sup> See 12 U.S.C. § 1821(e)(1).

<sup>22</sup> 12 U.S.C. § 1821(e)(12).

<sup>23</sup> 12 U.S.C. § 1821(e)(8).

<sup>24</sup> 12 U.S.C. §§ 1821(d)(12) and 1821(d)(13)(D).

<sup>25</sup> 12 U.S.C. §§ 1821(d)(3)–(10), (12)–(13).

<sup>26</sup> Financial Stability Forum, “Guidance for Developing Effective Deposit Insurance Systems,” at 34–36 (September 2001).

<sup>27</sup> 12 U.S.C. § 1821(a).

<sup>28</sup> 12 U.S.C. § 1821(d)(11).

<sup>29</sup> 12 U.S.C. § 1823(c)(4).

<sup>30</sup> 12 U.S.C. § 1823(c)(4)(G).

<sup>31</sup> See, e.g., G-10 Contact Group on the Legal and Institutional Underpinnings of the International Financial System, “Insolvency Arrangements and Contract Enforceability,” at Appendix A (September 2002); Richard Herring, “International Financial Conglomerates: Implications for Insolvency Regimes,” in George G. Kaufman, ed., *Market Discipline in Banking: Theory and Evidence*, at 99 (Boston: Elsevier, 2003).

<sup>32</sup> EU Insolvency Regulation (EC) No. 1346/2000 of May 29, 2000; the Winding Up Directive for insurance undertakings 2001/17/EC of March 19, 2001; and the Winding Up Directive for credit institutions 2001/24/EC of April 4, 2001; see G-10 Contact Group on the Legal and Institutional Underpinnings of the International Financial System, “Insolvency Arrange-

ments and Contract Enforceability,” Appendix A, at A16–17 (September 2002).

<sup>33</sup> See Board of Governors of the Federal Reserve System, Department of the Treasury, and the Securities and Exchange Commission, “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System” (April 7, 2003); Erwin Nierop and Mikael Stenstrom, “Cross-Border Aspects of Insolvency Proceedings for Credit Institutions—A Legal Perspective,” Paper delivered at the International Seminar on Legal and Regulatory Aspects of Financial Stability, Basel, Switzerland, January 21–23, 2002; Kai Barvell, “Risks and Developments in Payment Systems,” in *Current Developments in Monetary and Financial Law*, Vol. 3, at 625 (Washington: IMF, 2005); Herring, *supra* note 31; Bank for International Settlements, Report of the Committee on Interbank Netting Schemes (Lamfalussy Report) (November 1990).

<sup>34</sup> For a valuable discussion of growing cooperation and the application of international precedents in cross-border litigation, see Anne-Marie Slaughter, “A Global Community of Courts,” 44 *Harvard International Law Journal* 191 (Winter 2003).

<sup>35</sup> An example of this approach is the EU Directive 2001/24/EC of April 4, 2001 on the reorganization and winding up of credit institutions. The Directive confers on the “administrative or judicial authorities of the home member state” the authority to decide and implement “reorganization measures” or “winding up (liquidation) proceedings” (Article 3 and Article 9). The “home member state” is defined, in short, as the original chartering authority for the bank (Article 2). See Antonio Sainz de Vicuna, General Counsel, European Central Bank, “Cross-Border Aspects of Insolvency and the Principles of Universality and Territoriality,” comments delivered at the Insolvency Symposium, European Central Bank, Frankfurt, Germany, September 30–October 1, 2003.

<sup>36</sup> See Note, Roland Lechner, “Waking from the Jurisdictional Nightmare of Multinational Default: The European Council Regulation on Insolvency Proceedings,” 19 *Arizona Journal of International and Comparative Law* 975, at 985–1000 (Fall 2002).

<sup>37</sup> See G-10 Contact Group on the Legal and Institutional Underpinnings of the International Financial System, “Insolvency Arrangements and Contract Enforceability,” Appendix A, at A13 (September 2002); Note, Roland Lechner, “Waking from the Jurisdictional Nightmare of Multinational Default: The European Council Regulation on Insolvency Proceedings,” 19 *Arizona Journal of International and Comparative Law* 975, at 985–1000 (Fall 2002).



<sup>38</sup> See Nielsen, Sigal, and Wagner, “The Cross-Border Insolvency Concordat: Principles to Facilitate the Resolution of International Insolvencies,” 70 *American Bankruptcy Law Journal* 533, at 537–38 (Fall 1996).

<sup>39</sup> See *id.* Principles 1–4, 8.

<sup>40</sup> See Jay L. Westbrook, “Multinational Enterprises in General Default: Chapter 15, the ALI Principles, and the EU Insolvency Regulation,” 76 *American Bankruptcy Law Journal* 1, at 4 (Winter 2002); Peter J. Murphy, “Why Won’t the Leaders Lead? The Need for National Governments to Replace Academics and Practitioners in the Effort to Reform the Muddled World of International Insolvency,” 34 *University of Miami Inter-American Law Review* 121, at 130–31 (Winter 2002).

<sup>41</sup> See list of nations with closeout netting laws in effect, <http://www.isda.org>; see also Herring, *supra* note 31.

<sup>42</sup> See UNCITRAL Model Law, <http://www.uncitral.org>; Simeon Sahaydachny, “The UNCITRAL Model Law on Cross-Border Insolvency,” presentation at the International Conference on Deposit Insurance, FDIC, Washington, September 9–11, 1998; Erwin Nierop and Mikael Stenstrom, “Cross-Border Aspects of Insolvency Proceedings for Credit Institutions—A Legal Perspective,” at 6–8, Paper delivered at the International Seminar on Legal and Regulatory Aspects of Financial Stability, Basel, Switzerland, January 21–23, 2002.

<sup>43</sup> EU Directive 2001/24/EC of April 4, 2001, Articles 3, 9, 10, and 21.

<sup>44</sup> EU Directive 2001/24/EC of April 4, 2001, Articles 25 and 26; see also Articles 21, 23, and 27.

<sup>45</sup> EU Directive 98/26/EC of May 19, 1998 on settlement finality in payment and securities settlement systems, Article 3; Erwin Nierop and Mikael Stenstrom, “Cross-Border Aspects of Insolvency Proceedings for Credit Institutions—A Legal Perspective,” at 16, Paper delivered at the International Seminar on Legal and Regulatory Aspects of Financial Stability, Basel, Switzerland, January 21–23, 2002.

<sup>46</sup> See Andrew Campbell, “Issues in Cross-Border Bank Insolvency: The European Community Directive on the Reorganization and Winding-Up of Credit Institutions,” in *Current Developments in Monetary and Financial Law*, Vol. 3, at 515 (Washington: IMF, 2005); see Jay L. Westbrook, “Multinational Enterprises in General Default: Chapter 15, the ALI Principles, and the EU Insolvency Regulation,” 76 *American Bankruptcy Law Journal* 1, at 34–35 (Winter 2002).

<sup>47</sup> See President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," at 27 and Appendix E (April 1999); Kai Barvell, "Risks and Developments in Payment Systems," in *Current Developments in Monetary and Financial Law*, Vol. 3, at 643–49 (Washington: IMF, 2005).

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## **IX. LAW REFORM IN INDONESIA: A CASE STUDY**

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DANIEL S. LEV

A careful survey of legal/judicial reform and good governance programs in such complex conditions as those in Indonesia, and a few other countries, might show two contradictory realities. One is that by and large they fail. The other is that they are sometimes oddly successful despite themselves. They do not achieve what they hoped to achieve, certainly not in the short time frames established, but sometimes they begin to lay the foundation of empirical knowledge and conceptual frameworks that are essential to such programs, but only recently have they begun to be taken seriously—and then not always consciously. Legal reform is exceedingly important work in the modern state. It is also exceedingly frustrating, depressing, infuriating work, and it needs to be said bluntly that it requires exceedingly competent, thoughtful, imaginative people to do it. It is not easy to find figures as able as Sebastiaan Pompe, who has been in charge of the legal/judicial reform program in Jakarta, and his resident advisor colleagues. They deserve respect and encouragement, but also argument.

Indonesia stands out for the extent to which its state was reduced to institutional shambles over a period of 40 years. Some comparable though differing examples might include Nigeria and Sudan as well as several other African countries, and Burma in Southeast Asia. Contrasts in Asia would include South Korea, Thailand, and Malaysia, each of which retained substantial institutional integrity during periods of rapid economic and social change. In mid-1998, when President Suharto resigned his office, not a single principal institution of the state remained reasonably healthy. Corruption, incompetence, misorientation, and organizational breakdown were characteristic. The courts, prosecution, and police were underfunded and self-funded. All had been subjugated by political authority since at least 1960 and allowed substantial leeway, within the terms of their subor-

dination, to fend for themselves. Legal process had little integrity left, as was equally true of public policy.

In these conditions, how is it possible to conceive a sensible approach to reform, particularly legal reform? Many donor countries and agencies sought to engage: from 1998 onward, substantial funds supported endless conferences on law—often enough in English—new nongovernmental organizations (NGOs) oriented to legal reform, and new programs usually concerned with specific legal issues or problems. Similarly, there were political reform supports run by the United Nations Development Program, United States Agency for International Development, the Australian Agency for International Development, the World Bank, and others. What was lacking in most cases, apart from determined coordination among them, was a clear strategy of reform, a set of principles that provided starting points, and thoughtful consideration of how to mesh programs in support of one another. Many of the difficulties that arose almost immediately, as legal reform programs or projects were put in place, were rooted in misunderstandings, mythologies often, of state, of law, of political and legal process, and how they related to and intersected with one another.

For a relevant example, many, but not all by any means, concerned with legal reform evidently assumed that law and legal process stand on their own. Some, as in the Harvard projects of the 1970s and 1980s, simply sought to help draft new laws, or imported them from abroad as exemplary models, as if a law were somehow automatically enforceable, capable of exacting obedience simply by its existence. Others presupposed that judicial reform was largely a matter of allowing judges an opportunity to witness judicial operations in law-oriented countries, particularly in Europe and North America. Still others, significantly the International Monetary Fund (IMF), focused as it was on economic stabilization and reform, set about changing the bankruptcy regime, establishing new commercial courts, and, equipped with knowledgeable expertise on the ground, hoping for the best.

Law does not stand alone, but rests on a political base, which implies that reform-oriented outsiders and insiders alike must first analyze strategic possibilities for short-term and long-term progress, given potential support or resistance from political leadership and its

organizational base. There are basically two approaches to deep reform. One is dramatic, quick, and effective, essentially Napoleonic, and consists quite literally of getting rid of old institutions, replacing them with new ones, and inventing new rules. This sort of approach depends on a rare opportunity, however, one in which an existing elite has disappeared or has surrendered its authority or fled, as in the French revolution of 1789 or, perhaps, the Meiji Restoration in late nineteenth century Japan. Otherwise, the process of change is slow, gradual, difficult, expensive, and in constant need of rethinking, readjustment, and adaptation.

In the Indonesian case, the old elite did not disappear, and the army—the prime instrument of political control from the late 1950s through 1998—though chastised and in partial retreat politically, remained (and remains) significantly engaged. Political leadership had every interest in opposing or delaying effective political and legal reform, which inevitably would destroy or seriously undercut their authority. Given these realities, reform was bound to be gradual and uncertain and required careful consideration of strategic possibilities for the short and long term, with little guarantee, however, that any given measure would successfully take hold.

The IMF decision to assist in the creation of commercial courts suffered from two or three disabilities. Conceived as a substantial part of a solution to a difficult economic problem, the decision was made in awareness of and yet divorced from the realities of generally weak legal and judicial orders and a lack of full political interest and support. In this case, the capacity of the new courts was doubtful from the start. It is too easy to say this in retrospect, of course, but there were some questions that deserved to be posed (and were) and measures taken (that were not) that might have made the prospects of the commercial courts rather brighter.

The most problematic issues had to do with the selection of commercial court judges and their organizational direction. Given conditions in the civil courts, from first instance through the appellate courts and Supreme Court, it probably made sense to avoid commercial court appointments from among sitting judges and, as well, to avoid placing the new courts physically in existing judicial settings. There were capable judges, but established judicial habits and attitudes increased the likelihood of corruption and of a too-easy ac-



commodation with private lawyers inclined to corruption and procedural manipulation. The alternative was to appoint ad hoc judges from among private lawyers with strong reputations and a willingness to devote time for the sake of judicial reform and to place the new courts not in existing first or second instance courthouses but in their own headquarters to demarcate their distinction from existing judicial institutions. Originally, it seems, the idea was indeed not to rely on existing judges, but the judges association (IKAHI) appealed to the then Minister of Justice—the Department of Justice was then still administratively responsible for the courts—not to allow appointments from outside of the judicial corps.

The minister agreed with IKAHI's position, and the IMF/Netherlands program followed suit. It is worth asking whether, in the circumstances, it might have been justified to use IMF leverage through a Letter of Intent to insist on strategic leeway to appoint ad hoc judges. The objection is that to do so would, in effect, have been too intrusive. Many in and out of Indonesia would agree. After all, however, the very presence of the IMF and the use for other purposes of demanding Letters of Intent are equally intrusive. If a more effective bankruptcy regime was the imperatively hoped-for result from the new commercial courts, then such pressure was presumably legitimate. As it was, however, resistance to reform won out for lack of strategic pressure.

As part of a solution for the bankruptcy problem, the new commercial courts failed. Within a relatively short time after their inception, there were reports of corruption, of questionable decisions—along with competent ones, and according to one analysis more so than was true of the Supreme Court—of too much influence by private lawyers inclined to questionable tactics and bribery, of a divided receivers association that further complicated the work of the courts, and of administrative problems associated with the status of commercial court judges still linked to their home courts in the state judiciary. The point is not that the commercial courts are beyond hope—efforts to improve them continue—but rather that they did not serve the purpose for which they were intended when they were most needed.

They helped to serve another purpose, however, and one that may actually supersede in importance the original impetus for inventing the commercial courts. It is worth arguing that absent more funda-

mental legal reforms, the commercial courts would not in any case have been very useful to the program of economic recovery. It is to the credit of Pompe and his colleagues that they evidently understood, from the start, that the prior problem that needed to be addressed was not at the periphery but at the center of judicial institutions, in the Supreme Court, and that so long as judicial incompetence and corruption were not addressed, there would be little hope for legal reform generally. As grounds for dealing with the Supreme Court, on the one hand, and corruption on the other, the commercial courts served an incomparably more important problem that had to do, at its widest understanding, with reconstruction of the Indonesian state, or, in any case, with a significant portion of that problem.

This wider program of reform, particularly as it affects the Supreme Court of Indonesia, has been impressively complex and has engaged (and encouraged) promising and important NGOs, new ideas, new personnel, and new reform strategies in what may be one of the most intriguing and forward-looking efforts one can imagine over the last several decades. The Netherlands funding of the program and IMF administration of it have been impressive, sophisticated, demanding, and, in many ways, effective. How successful they will turn out to be is now beyond prediction, and the difficulties they face are enormous, but there is little question that they have made a significant mark, that they have momentum, and that many in a new generation of lawyers and reformers have been engaged and will remain so.

Still, as programs of legal reform—not merely judicial reform linked singularly to economic repair, but legal-institutional reform that will of course serve much wider economic, social, and political purposes—one can argue that they fall short, for no other reason than that legal systems are complex and require broader attention than is satisfied by any single institution within a given system. To take one brief example, a program that addresses judicial institutions will necessarily fall short unless it also addresses legal education and, perhaps, the private legal profession. Legal education is the more basic and influential instrument of change, for the obvious reason that on its quality will depend the quality of future judges, prosecutors, notaries, private lawyers, certain police officials, corporate house lawyers, inevitably many members of parliament, and so on. It is of course easy

to make an argument about limits on any program of change. Improving legal education is expensive and difficult. It is also worth it.

One last question that needs attention is this: why should the IMF do such work? By the time I revise this brief paper, the question may be beside the point, but there are two kinds of answer. One is that, in the Indonesian case at least, the IMF/Netherlands program in legal and judicial reform has been impressively effective in the most difficult of circumstances. Indonesian professionals of various sorts who have bones to pick with the IMF are equally quick to state their admiration for the legal reform program. They appreciate its flexibility, adaptability, and imagination, as well as the quality of its personnel, and the extent to which its leadership has understood the fundamental point that success in such programs depends on the extent to which they are locally oriented and rooted. Their approval and support constitutes impressive praise.

The other reason has to do with the IMF itself. It is that such programs, certainly this one, engaged in an extraordinarily difficult effort of legal institutional reform in one of the world's most complex countries, may have the effect of demonstrating that economic problems are seldom economic problems alone.

CEDA OGADA

The 1997–98 financial crisis in Indonesia spawned a wave of law reform to deal with the crisis and its aftermath. Many of the ensuing legal, judicial, and governance reforms were included as part of Indonesia’s International Monetary Fund (IMF)-supported economic recovery programs. The initial focus of these legal, judicial, and governance reforms under the IMF-supported programs was to address the problem of widespread corporate insolvencies, which were a major factor in the collapse of the banking sector.<sup>1</sup> In this regard, the principal elements of Indonesia’s strategy for corporate debt and bank restructuring consisted of (1) adopting a modern bankruptcy law; (2) establishing a new, specialized Commercial Court to handle insolvencies; (3) facilitating out-of-court corporate debt workouts; (4) stabilizing and strengthening the banking sector through the establishment of the Indonesian Bank Restructuring Agency (IBRA); and (5) eliminating foreign exchange rate risk on future debt-service payments for debtors and creditors reaching debt restructuring agreements through the Indonesian Debt Restructuring Agency.<sup>2</sup>

This chapter examines the third element of the strategy outlined above—the facilitation of out-of-court corporate debt workouts. The role of such facilitation was entrusted to the Jakarta Initiative Task Force (JITF), a new governmental agency inaugurated in November 1998. By the time of its winding-up in December 2003, the JITF had handled well over 100 cases, involving close to US\$30 billion of corporate debt.<sup>3</sup> The chapter will examine the design, establishment, operations, and impact of the JITF and will seek to derive from that examination a few general lessons for law reform and related technical assistance.

The remainder of the chapter is organized as follows. The first section describes the problem of corporate debt overhang, while the

second section discusses how Indonesia sought to resolve the corporate debt problem through the design and establishment of the JITF. Next, the challenges faced by the JITF are examined, as well as this agency's achievements and impact. The final section draws some broad lessons for law reform and related technical assistance.

### **The Overhang of Corporate Debt**

Following on from the financial crisis that hit Indonesia in 1997–98, the country faced the problem of widespread corporate defaults, which, in turn, were a major factor in the collapse of the banking system. The scale of the problem is demonstrated by the massive figures involved. As of November 1998, total nonfinancial corporate debt was estimated at about US\$120 billion. Of this, roughly 60 percent comprised external debt and 40 percent was owed to domestic creditors. The amount owed externally represented close to half of Indonesia's total external debt; corporate debt, therefore, represented a huge international exposure for Indonesia. In addition, much of the debt owed by corporations to domestic creditors was denominated in foreign currency. As a result, about 75 percent of total corporate debt was denominated in foreign currency.<sup>4</sup>

With the rapid collapse of the rupiah during the crisis, most companies were unable to service the huge foreign currency debt, and almost half of all corporations were thought to be insolvent.<sup>5</sup> Given the size of the figures cited above, there was no question about the urgent need to resolve the corporate sector crisis in Indonesia.<sup>6</sup> The question, however, was how the large number of corporate insolvencies would be resolved. While so many insolvencies occurring at the same time would test even the most hardy judicial systems, the problem was particularly acute in Indonesia, given its weak judicial system and the relative lack of experience in the country on insolvency matters. As such, Indonesia was faced with the real potential that the insolvencies would overwhelm the judicial system, in particular, the newly established Commercial Court with jurisdiction for insolvency cases.<sup>7</sup>

## **Facilitating Out-of-Court Workouts—Design and Establishment of the JITF**

Faced with a large number of corporate insolvencies that could overwhelm the judicial system, Indonesia recognized that an out-of-court negotiating framework would be critical in assisting with the resolution of corporate debt.<sup>8</sup> This realization led to the establishment of the JITF in November 1998. However, before turning to the JITF, it is useful to step back and to take a look at the underlying economic rationale for such out-of-court negotiating frameworks.

### **Rationale for Out-of-Court Frameworks**

In principle, to avoid the risks and costs of formal insolvency proceedings, debtors and creditors prefer out-of-court negotiations. The potential initiation of formal insolvency proceedings, with its risks and costs, provides an incentive to conclude out-of-court agreements. If the laws, practices, and decisions regarding rights and obligations that are applicable in the formal system provide clear and predictable guidelines on rights, obligations, and their enforcement, then, in the out-of-court framework, debtors and creditors should be able to assess their respective leverage and make commercially reasonable decisions. Thus, the law, practices, and decisions provide the parameters within which negotiations will take place. As such, the negotiations are said to take place “in the shadow of the law.”<sup>9</sup>

From the standpoint of governments and of international financial institutions (IFIs), such as the IMF or the World Bank, out-of-court negotiations (and more generally, rehabilitation—as opposed to liquidation—procedures) are particularly important in the context of a financial crisis. This is because such negotiations ensure that private sector creditors contribute to the resolution of financial crises by bearing part of the costs of the risks that they incur. Such involvement of the private sector in crisis resolution is important because it reduces the public cost of resolving crises, relieves external financing needs faced by the country, and strengthens the stability of the international financial system by limiting the size of official “bailouts.”<sup>10</sup>

Turning back to Indonesia, the 1998 Bankruptcy Law amendments encompassed the rationale for out-of-court negotiations described above. The law achieved this in two main ways. First, as a general matter, it provided the right incentives for creditors and debtors to restructure debt by providing for an effective credit enforcement mechanism, underpinned by a strengthened institutional infrastructure (including the new Commercial Court) and a revamped procedural framework (in particular, to speed up the resolution of cases). Second, and more specifically, the law promoted out-of-court negotiations by supporting the rehabilitation of debtor companies through addressing inter-creditor issues:

- The law introduced restrictions on the ability of secured creditors to foreclose on collateral during bankruptcy proceedings—once an insolvency petition is filed, there is a 90-day period during which collateral may not be foreclosed. The aim is to give negotiations a chance. The period can be extended under certain circumstances.
- The law provided for interim priority financing to enable businesses to continue operating even after an insolvency petition is filed.
- The law allowed for the ability to bind in dissenting unsecured creditors following approval by the Commercial Court of a debtor’s restructuring plan agreed to by the requisite majority of creditors (this is because it is difficult to obtain unanimity of creditors on a restructuring plan).<sup>11</sup>

The 1998 Bankruptcy Law provided clear and transparent rules, designed to facilitate out-of-court negotiations by enabling debtors and creditors to assess their respective leverage and to make commercially reasonable decisions. However, as discussed further below, effective corporate debt restructuring was hampered by the ineffective implementation of the rules, as reflected in some of the poor practices that developed within the insolvency system and by a number of controversial court decisions that seemed difficult to square with the rules.

## **Design and Establishment of the JITF**

With advice from the IMF and the World Bank, the JITF was modeled on workout techniques followed in other countries.<sup>12</sup> In particular, the JITF built upon the so-called “London Approach,” which consists of a set of nonbinding guidelines developed by the Bank of England.<sup>13</sup> This approach was chosen because it allowed for a framework in which the government could facilitate negotiations, but in which public funds would not be provided to distressed firms.<sup>14</sup> Moreover, the London Approach represented generally accepted debt restructuring principles on which there was already a commercial consensus and with which external creditors were familiar.<sup>15</sup> Broadly, the London Approach consists of the following features:

- Creditors are urged to take a supportive attitude toward debtors in financial difficulties;
- Decisions about debtors’ long-term future are made only on the basis of comprehensive information, which is shared among creditors;
- Sufficient information is made available to creditors so that creditors can effectively evaluate the restructuring proposals of debtor companies; and
- Interim financing is facilitated.<sup>16</sup>

In the United Kingdom and other jurisdictions, the approaches used are rather informal and there are no elaborate institutional infrastructures in place. This is possible because, among other things, these jurisdictions have a tradition of, and a set of agreed practices for, resolving issues out of court. In addition, they also possess the necessary negotiating and other technical expertise in good supply. In the case of Indonesia, the absence of these factors required a design that would include an institutionalized infrastructure to effect the approach. This infrastructure had three main elements that went beyond the typical London Approach.

First, a key distinction from the London Approach was that a governmental entity, the JITF, was actively involved in facilitating deal making.<sup>17</sup> As a governmental agency, the JITF was subject to the supervision of an inter-ministerial committee known as the Financial



Sector Policy Committee (FSPC).<sup>18</sup> In addition, its managerial and support staff were employed by the government, and restructuring and mediation experts, who were lacking in Indonesia, were also hired from abroad by the government. Much of the required funding for these experts and for other financing needs of the JITF were provided through a World Bank loan.<sup>19</sup> Second, the JITF was designed as a “one-stop” forum for the facilitation of regulatory applications required for restructuring plans (previously procedures were decentralized and time-consuming).<sup>20</sup> In particular, in this role, it was charged with recommending incentives for restructuring and removal of disincentives regarding, for example, taxation, legal lending limits, disclosure of financial information, and divestiture by banks of equity acquired in restructuring transactions.<sup>21</sup> Third, the FSPC, which, like the JITF, was a governmental body, was empowered to direct certain cases deemed of strategic importance to be restructured under the JITF.<sup>22</sup> In addition, the FSPC was charged with overseeing the JITF and IBRA to ensure effective cooperation between the two.<sup>23</sup>

### **JITF Restructuring Principles**

The JITF established a set of restructuring principles and mediation procedures, which, among other things, called on parties to proceed according to the following rules:

- Refrain from effecting liquidation of viable companies while restructuring discussions were proceeding;
- Share information on a transparent basis;
- Form creditors’ committees as necessary; and
- Respect the time-bound mediation procedures and requirements on the conduct of parties.<sup>24</sup>

In addition, the JITF was authorized to recommend sanctions for “bad-faith” behavior to the FSPC. For example, parties that were found not to respect deadlines, not to show up for mediation meetings, or not to provide required information could be found to be in bad faith and recommended for sanctions. In this regard, names of bad-faith parties could be published, licenses and concessions could be revoked or not renewed, a company could be delisted from the stock exchange, and public interest bankruptcy petitions against un-

cooperative debtors could be recommended.<sup>25</sup> The JITF did recommend about 40 cases to the FSPC.<sup>26</sup> However, the FSPC was perceived as doing little to pursue the recommended cases.

### **Challenges Faced by the JITF**

Following its establishment, the JITF was confronted with significant operational challenges. The initial design of the JITF, building on the London Approach, focused on an informal framework that was devoid of a system of sanctions. A basic assumption of the design was that there would be adequate political support and coordination within government for achieving the JITF's mandate, sufficient budgetary and infrastructural support, and an effective system for the adjudication of insolvency cases and their enforcement. However, as it turned out, corporate restructuring, both within and outside the JITF framework, had to confront a number of difficult obstacles in these areas, as well as in connection with the macroeconomic environment.<sup>27</sup>

#### **Political and Institutional Challenges**

A key obstacle to making the JITF operational was the political context in which it was established. As a general matter, the legal, judicial, and governance reforms that were agreed to under successive IMF-supported economic programs were never able to obtain the benefit of adequate, sustained, high-level, political support for decisive and fundamental change in these areas; vested interests resistant to change were able to exert their influence. More specifically with regard to corporate debt restructuring, there was widespread political resistance to the potential acquisition by external creditors of large ownership positions in domestic companies that restructuring deals under the JITF, or other forums, might entail.<sup>28</sup> Further, a class of large debtors known to wield political influence seemed able to exercise that influence and remained impervious to the incentives and sanctions offered under the JITF framework.<sup>29</sup>

At an institutional level, the lack of political will had a number of consequences. The lack of strong political backing for the JITF led to long delays in getting it operational, thereby impeding its overall effectiveness. Thus, although launched in November 1998, it was not until a year later that the JITF began to obtain sufficient political

backing, funding, staffing, and infrastructure. By that time, some of the initial momentum and goodwill toward it had dissipated and doubts about its effectiveness were raised.<sup>30</sup> Another manifestation of the absence of political will was the poor nature of coordination and cooperation on debt restructuring, both within the government generally and, more particularly, between the JITF and IBRA. The lack of such coordination resulted in the inadequate integration of the JITF into the political and governmental levers of power and detracted from its effectiveness and credibility.<sup>31</sup> Moreover, important potential synergies between the JITF and IBRA could not be realized under the circumstances.<sup>32</sup> In addition, poor interagency coordination within the government made it difficult to make the JITF an effective “one-stop” forum for regulatory facilitation, and as of early 2000 the government was still trying to get the agreement of the relevant agencies.<sup>33</sup>

### **Shortcomings of the Legal System**

In addition to the political and institutional hurdles, the legal system failed to pose a credible threat to debtors that refused to restructure in good faith. As discussed above, out-of-court restructurings were designed to take place “in the shadow of the law.” In this regard, while the provisions of the Bankruptcy Law were clear and transparent, the application of the law by the courts proved to be unpredictable, and thus failed to provide sufficient and consistent incentives for debt restructuring. In particular, legal analysts have concluded that a number of controversial rulings by the Commercial Court in favor of debtors could not be supported by provisions of the law, and they suspect that inappropriate external influences played an important role. These rulings served to shape a recalcitrant attitude among some debtors toward negotiations within the JITF framework. This was particularly true for certain large, politically well-connected debtors referred to above.<sup>34</sup> Many cases involving these debtors eventually had to be de-registered from the JITF caseload.<sup>35</sup> More generally, the delays and governance problems in the legal system as a whole made it difficult for creditors to enforce their claims, including foreclosing on collateral. This situation provided little incentive for debtors to engage in restructuring negotiations.<sup>36</sup>

## **Economic Factors**

On the economic front, many debtors were uncooperative about disclosing information on cash and other assets, without which, for example, interim financing could not be provided. Further, weak macroeconomic conditions encouraged some debtors to delay restructuring in the hope that the rupiah would appreciate, thus reducing their foreign currency debt. In addition, the sustainability of many of the deals reached were questioned since only about half the dollar amount restructured involved robust measures like debt-equity swaps, buy-backs, write-offs, and cash payments. Also, the steep depreciation of the rupiah in 2000 had significant impact on the ability of companies to service even recently restructured debt.<sup>37</sup> As a result, some creditors came to believe that the JITF process simply served to allow uncooperative debtors to buy time on real restructuring.<sup>38</sup>

## **Response to Challenges**

Various attempts were made, with varying success, to respond to the challenges discussed above. In particular, in early 2000, the government committed to “giving new political leadership and direction to the corporate restructuring strategy.”<sup>39</sup> Coordination and cooperation between IBRA and the JITF was recognized as a key element of the reinvigorated strategy.<sup>40</sup> With IMF and World Bank assistance, the design of the JITF was revamped and its procedures were strengthened.<sup>41</sup> The government also committed to providing the resources necessary for the JITF to fulfill its mandate in a timely manner.<sup>42</sup> Many of these measures were in place by May 2000, following which performance under the JITF showed marked improvement.<sup>43</sup>

## **Achievements and Impact of the JITF**

In its five years (1998–2003), the JITF played the role of mediator in well over 100 cases, involving more than 300 companies and close to US\$30 billion of debt. With respect to at least US\$20.5 billion of that debt (about 70 percent of the dollar amount of total debt registered under the JITF), the parties were able to reach final legal closure or conclude memoranda of understanding as a prelude to final legal closure. This restructured debt comprised about a third of the total corporate debt in distress in Indonesia as a result of the crisis. On the remaining US\$9 billion of debt (30 percent of the dollar

amount of total JITF-registered debt), no agreement could be reached and the cases were removed from the register. In addition, the JITF estimates that its efforts made it possible for companies employing a total of over 300,000 people to restructure their debt and to return to profitability.<sup>44</sup>

On balance, Indonesia achieved considerable success in corporate debt restructuring. The legal and institutional framework for out-of-court corporate debt and bank restructuring was successfully put into place. In particular, the JITF contributed substantially to debt resolution and to economic recovery. In the absence of a credible legal system and within a difficult political environment, the JITF provided a predictable, neutral, transparent framework for restructuring. In the end, however, the absence of a credible legal threat led many creditors and debtors to focus on the difficult ultimate issues of control and debt forgiveness rather than on intermediate issues such as interim financing that could have better promoted corporate rehabilitation.<sup>45</sup> The lack of confidence that creditor rights would be protected led some debtors and creditors either to shun negotiations or to adopt extreme negotiating postures.<sup>46</sup>

In terms of its broader legacy, the JITF process led to a wider recognition in Indonesia of the usefulness of alternative dispute resolution. The JITF also contributed to the development of debt restructuring expertise in Indonesia. Many former JITF staff are involved in a new mediation center announced in September 2003, which is intended to provide general mediation and training. The center, the Indonesian National Mediation Center, is expected to cooperate with the judiciary, which has adopted regulations requiring commercial disputes to be mediated prior to litigation.<sup>47</sup> In addition, the JITF process also played an important role in improving the secondary debt market as some of the restructuring deals involved debt buy-back schemes.<sup>48</sup>

### **Lessons for Law Reform in General**

The experience of the JITF highlights a number of key ingredients that are necessary for effective and sustainable law reform in developing countries, particularly where vested economic rights are at stake and when an economy is in the throes of a financial crisis. In

the case of the JITF, three such factors were particularly instrumental—political will and institutional arrangements, technical capacity, and donor support and coordination. While the importance of these particular factors for law reform are self-evident and well-known, and therefore perhaps uncontroversial, they are so critical that they bear being repeated.

### **Political Will and Institutional Arrangements**

As discussed above, the lack of adequate, sustained high-level political will to support the JITF undermined its credibility and effectiveness through a number of means, including the long delays in becoming operational, the poor coordination within government, the recalcitrance shown by politically well-connected debtors as a result of the failures of the legal system, the lack of robust enforcement of the system of sanctions under the JITF framework, and the lack of confidence in the JITF instilled in many creditors.

When the government announced its commitment in early 2000 to reinvigorate the JITF and, more generally, its corporate debt restructuring strategy, and then began to implement that commitment, a marked improvement in performance under the JITF was soon registered. Had that political support been there continuously from the outset, the JITF would likely have achieved even more than it managed to achieve. This experience teaches the following lessons for the design of law reform programs involving institutional changes:

- The nature and level of political will must be taken into account.
- Institutions should not be seen in isolation; the necessary coordination mechanisms within government (or with outside entities as appropriate) must be addressed at the design stage.<sup>49</sup> In this regard, clear lines of political accountability for the program should be established.<sup>50</sup>
- Program design should include sufficient flexibility to accommodate necessary program adjustments as experience grows with implementation and as the political context and practical realities change.
- Adequate institutional resources, including funding, staffing, and infrastructure, need to be made available up front.

## Technical Capacity

From the outset, the JITF program design recognized that Indonesia lacked the necessary expertise in debt restructuring and mediation. The IMF and the World Bank worked with the government to identify the requisite foreign expertise, willing to stay in Indonesia for the long haul and committed to engaging in a real transfer of skills to Indonesians. In addition, program design paid attention to introducing sound restructuring principles and mediation procedures and adapting them to local circumstances. When the procedures did not work as intended, more robust procedures were introduced. These successes point to the following general lessons for law reform programs:

- Programs should avoid prescribing remedies without ensuring that the requisite technical capacity exists, either from local or foreign sources.
- Where foreign expertise is used, every attempt should be made to locate experts who are willing to stay for as long as necessary and to engage in a real transfer of skills to local professionals, thus leading to long-term sustainability of program goals.<sup>51</sup>

## Donor Support and Coordination

The IMF and the World Bank were the key donors associated with the JITF. The agencies worked closely in assisting Indonesia in designing the JITF, but also in monitoring its progress and suggesting needed adjustments in design and implementation. This involvement with the JITF continued throughout the life of the JITF. Further, much of the funding for the JITF was provided through a World Bank loan. The key lessons are as follows:

- Complex law reform programs, such as the establishment of a new institution to deal with issues that have not previously been dealt with in a particular country, often require strong external donor support, both technically and financially.
- In providing such support, donors need to work together in order to minimize institutional rivalry that can lead to wasteful competition and duplication. Even more important, care must be taken to ensure that donor priorities do not distort the real needs of the re-

ipient country. To this end, program design should seek, to the extent feasible, to engage local stakeholders and constituencies for reform by directly involving them in the program activities at the design, implementation, monitoring, and evaluation stages.<sup>52</sup>

- Donors should be prepared to be involved for the long haul, rather than simply helping in design and then fading from the scene. Continuous technical support and monitoring and timely provision of adequate financing need to be key aspects of program design.



## Notes

<sup>1</sup> See generally, IMF, *Indonesia—Selected Issues*, Chapter IV, “Legal, Judicial, and Governance Reforms,” April 16, 2004, IMF Staff Country Report No. 04/189 [hereinafter IMF Staff Country Report No. 04/189], <http://www.imf.org/external/pubs/ft/scr/2004/cro4189.pdf>.

<sup>2</sup> See, e.g., Government of Indonesia, Second Supplementary Memorandum of Economic and Financial Policies, June 24, 1998, at paras. 12–13, <http://www.imf.org/external/np/loi/062498.htm>. See also Government of Indonesia, *JITF Final Report* (December 2003) [hereinafter *JITF Final Report*], at 14–16.

<sup>3</sup> *JITF Final Report*, at 3, 65–66.

<sup>4</sup> World Bank, *World Bank Brief on Corporate Restructuring in Indonesia*, March 1999, IMF Document No. EBD/99/46 [hereinafter *World Bank Brief*], unpublished, at 1–3, and Annex 1. In subsequent years, the proportion of foreign currency denominated corporate debt continued to be significant. See *JITF Final Report*, at 59–64.

<sup>5</sup> *World Bank Brief*, at 1; *JITF Final Report*, at 12.

<sup>6</sup> The unresolved corporate debt was a substantial drag on the economy. For example, the recovery of the domestic financial sector was stymied as there were fewer viable and performing companies to which banks could extend credit. Conversely, the debt overhang limited the ability of otherwise viable firms to access new financing, thus impacting negatively on their growth and their ability to sustain and create employment. See IMF, *Indonesia—Selected Issues*, Chapter III, “Corporate Debt Restructuring and Related Legal Reforms,” August 16, 2000, IMF Staff Country Report No. 00/132 [hereinafter IMF Country Staff Report No. 00/132], at 48, <http://www.imf.org/external/pubs/ft/scr/2004/cr04189.pdf>.

<sup>7</sup> *JITF Final Report*, at 11–12; IMF Staff Country Report No. 04/189, at 42.

<sup>8</sup> Government of Indonesia, “Memorandum of Economic and Financial Policies,” attached to the *Letter of Intent* to the IMF of July 29, 1998 [hereinafter “Memorandum of Economic and Financial Policies” (July 29, 1998)], at para. 14, <http://www.imf.org/external/np/loi/072998.htm>.

<sup>9</sup> IMF Staff Country Report No. 00/132, at 50. See also IMF Legal Department, *Orderly and Effective Insolvency Procedures—Key Issues* (Washington: IMF, 1999) [hereinafter *Orderly and Effective Insolvency Procedures*], at 15–16.

<sup>10</sup> *Orderly and Effective Insolvency Procedures*, at 53.

<sup>11</sup> See 1998 Bankruptcy Law, Law No. 4 of 1998.

<sup>12</sup> “Memorandum of Economic and Financial Policies” (July 29, 1998), at para. 16. These techniques, primarily used in the United States and Europe, are designed to rescue companies while also maximizing recovery for creditors.

<sup>13</sup> *JITF Final Report*, at 20.

<sup>14</sup> IMF Staff Country Report No. 00/132, at 49.

<sup>15</sup> *Id.* at 48.

<sup>16</sup> *Orderly and Effective Insolvency Procedures*, at 15–16.

<sup>17</sup> However, the JITF had no authority to dictate the terms of a deal. “Memorandum of Economic and Financial Policies” (July 29, 1998), at para. 14.

<sup>18</sup> Government of Indonesia, “Memorandum of Economic and Financial Policies,” attached to the *Letter of Intent* to the IMF of January 20, 2000 [hereinafter “Memorandum of Economic and Financial Policies” (January 20, 2000)], at para. 55, <http://www.imf.org/external/np/loi/2000/idn/01/index.htm>.

<sup>19</sup> Government of Indonesia, “Supplementary Memorandum of Economic and Financial Policies,” attached to the *Letter of Intent* to the IMF of November 13, 1998, at para. 23, <http://www.imf.org/external/np/loi/1113a98.htm>; Government of Indonesia, “Supplementary Memorandum of Economic and Financial Policies,” attached to the *Letter of Intent* to the IMF of March 16, 1999, at para. 38, <http://www.imf.org/external/np/loi/1999/031699.htm>.

Throughout the life of the JITF, the IMF and World Bank worked closely to advise Indonesia on designing the JITF, to monitor the JITF’s progress, and to suggest adjustments in its design and implementation. IMF and World Bank staff met jointly on a frequent basis with the authorities to discuss these issues, and technical assistance provided by both organizations was closely coordinated. Further, the IMF and the World Bank also worked in tandem to monitor the progress of the JITF on a continuous basis, including through the quarterly program reviews under the successive IMF-supported economic programs.

<sup>20</sup> Government of Indonesia, “Supplementary Memorandum of Economic and Financial Policies,” attached to the *Letter of Intent* to the IMF of September 11, 1998 [hereinafter “Supplementary Memorandum of Economic and Financial Policies” (September 11, 1998)], at para. 8, <http://www.imf.org/external/np/loi/091198.htm>.

<sup>21</sup> IMF Staff Country Report No. 04/189, at 42; *JITF Final Report*, at 30–31; “Supplementary Memorandum of Economic and Financial Policies” (September 11, 1998), at para. 8.

<sup>22</sup> *JITF Final Report*, at 2–3 of Annex 3. See also “Memorandum of Economic and Financial Policies” (January 20, 2000), at para. 58.

<sup>23</sup> “Memorandum of Economic and Financial Policies” (January 20, 2000), at para. 59; *JITF Final Report*, at 28, 31–32. As a general matter, given the obvious linkages between corporate debt restructuring and bank restructuring, the legal and regulatory framework had to be designed to promote coordination and cooperation between the two agencies. See *supra* note 6. More specifically, there was potential for synergies between the two. For example, on the one hand, in JITF deals in which it was involved, IBRA, as a major creditor, could play a catalytic role in bringing together debtors and creditors to act in a commercially reasonable manner. *JITF Final Report*, at 26–27; IMF Staff Country Report No. 00/132, at 48. On the other hand, the success of the JITF out-of-court process, could be expected to reduce the risk of the out-of-court framework for creditors generally and develop the secondary debt market, thereby increasing the secondary market value of IBRA’s own loan portfolio. IMF Staff Country Report No. 00/132, at 48; “Memorandum of Economic and Financial Policies” (January 20, 2000), at para. 59.

<sup>24</sup> *JITF Final Report*, at Annex 3.

<sup>25</sup> *JITF Final Report*, at 29–31, and at 6–7 of Annex 3; Government of Indonesia, “Memorandum of Economic and Financial Policies,” attached to the *Letter of Intent* to the IMF of May 17, 2000, para. 34, <http://www.imf.org/external/np/loi/2000/idn/02/index.htm>. The Bankruptcy Law authorizes the Attorney-General to institute bankruptcy petitions when such a petition is deemed to be in the public interest. In addition to recommendations to the Attorney-General regarding uncooperative behavior, the JITF could also recommend that the FSPC refer cases to the Attorney-General for criminal investigation when there was evidence of fraud. Government of Indonesia, “Memorandum of Economic and Financial Policies,” attached to the *Letter of Intent* to the IMF of July 31, 2000, at para. 41, <http://www.imf.org/external/np/loi/2000/idn/03/index.htm>.

<sup>26</sup> *JITF Final Report*, at 30.

<sup>27</sup> *JITF Final Report*, at 18–19, 23; IMF Staff Country Report No. 04/189, at 42.

<sup>28</sup> IMF Staff Country Report No. 00/132, at 54. See also *JITF Final Report*, at 25–26.

<sup>29</sup> *JITF Final Report*, at 9–11. See also IMF Staff Country Report No. 00/132, at 54.

<sup>30</sup> *JITF Final Report*, at 23, 25–26, 32.

<sup>31</sup> *Id.* at 25–26.

<sup>32</sup> See *supra* note 23. For example, for a number of years, IBRA was unable to add momentum to debt restructuring, within or outside the JITF, as government policy prohibited IBRA from agreeing to reductions in book value of debt. Even with such authority, IBRA was reluctant to act before being assured of some measure of legal protection for its officers who could be held personally liable for engaging in such debt reduction transactions. IMF Staff Country Report No.00/132, at 54, 55. Further, IBRA was perceived as keener to pursue the narrower objective of its own debt collection than on achieving the government’s broader corporate restructuring goals. *JITF Final Report*, at 27.

<sup>33</sup> IMF Staff Country Report No. 04/189, at 42; “Memorandum of Economic and Financial Policies” (January 20, 2000), at para. 61.

<sup>34</sup> IMF Staff Country Report No. 00/132, at 53; *JITF Final Report*, at 16, 23–24.

<sup>35</sup> *JITF Final Report*, at 35–36.

<sup>36</sup> IMF Staff Country Report No. 00/132, at 53; *JITF Final Report*, at 23–24.

<sup>37</sup> IMF Staff Country Report No. 00/132, at 54, 60–61.

<sup>38</sup> IMF Staff Country Report No. 04/189, at 43.

<sup>39</sup> “Memorandum of Economic and Financial Policies” (January 20, 2000), at para. 8.

<sup>40</sup> *Id.* at paras. 55–59.

<sup>41</sup> *Id.* at paras. 55, 58; *JITF Final Report*, at 28–32; IMF Staff Country Report No. 04/189, at 43.

<sup>42</sup> “Memorandum of Economic and Financial Policies” (January 20, 2000), at para. 60.

<sup>43</sup> “Memorandum of Economic and Financial Policies” (May 17, 2000), at para. 32–34; *JITF Final Report*, at 33–35; IMF Staff Country Report No. 04/189, at 43.

<sup>44</sup> *JITF Final Report*, at 3, 22, 51–52, 65–66.

<sup>45</sup> *Id.* at 3, 20–21, 23–25; IMF Staff Country Report No. 04/189, at 43.

<sup>46</sup> *JITF Final Report*, at 23–24; IMF Staff Country Report No. 00/132, at 50, 53.

<sup>47</sup> *JITF Final Report*, at 5–6, 46–47; IMF Staff Country Report No. 04/189, at 43.

<sup>48</sup> *JITF Final Report*, at 37, 51–52; IMF Staff Country Report No. 04/189, at 43.

<sup>49</sup> *E.g.*, coordination between JITF and IBRA, or relationship between JITF and the implementation of the bankruptcy framework by the courts.

<sup>50</sup> It was not until the FSPC, an inter-ministerial committee, was entrusted with supervision of the JITF, policy coordination of corporate restructuring generally, and, more particularly, coordination between the JITF and IBRA, that real political accountability for the law reform program was introduced and positive results began to be achieved.

<sup>51</sup> The Indonesian National Mediation Center is a testament to the JITF's development of a reservoir of skilled local restructuring and mediation experts who continue to serve Indonesia long after the foreign experts have left.

<sup>52</sup> A by-product of involving local stakeholders and reform constituencies may be that such groups can serve to provide the public pressure necessary to generate and maintain adequate, high-level political will for reform.

SHINJI TAKAGI

The 1990s saw a succession of currency crises in emerging market economies, against a background of greater integration with global capital markets. These crises were preceded by large private capital inflows and triggered by sudden shifts in market sentiment, leading to massive capital flow reversals. They are often described as capital account crises to distinguish them from the more conventional crises, which have their origins mainly in the current account.

The International Monetary Fund (IMF) was called in to help in several cases, and its role has been the subject of much study and comment.<sup>1</sup> Contrary to the expectation that IMF support would achieve a rapid turnaround in market sentiment, capital outflows continued, leading to severe exchange rate depreciation and, in some cases, an exceptionally large contraction in output. Stabilization was only achieved after further actions by national authorities, the IMF, and private creditors. Not surprisingly, the IMF was widely criticized both for its failure to anticipate vulnerabilities through surveillance during the precrisis period and for the subsequent failure to restore market confidence quickly.

The IMF's Independent Evaluation Office (IEO) took up an evaluation of the role of the IMF in three of these crises (Indonesia, Korea, and Brazil) as part of its first work program in 2002.<sup>2</sup> The evaluation work was completed, and a report was prepared and submitted to IMF management and the Executive Board, in the spring of 2003. The evaluation report assessed the effectiveness of the IMF in precrisis surveillance (primarily through Article IV consultations with the member countries aimed at identifying potential vulnerabilities) and crisis management (through adjustment policies supported by financing). This chapter discusses the major findings of the evaluation report,<sup>3</sup> explains the recommendations it made, and presents a

summary of the discussion of the report by the Executive Board, which was held in May 2003. Interested readers are invited to read the full text of the report, which was published along with management and staff responses and the Acting Chair's Summing Up of the Board discussion.<sup>4</sup>

The remainder of the discussion is organized as follows. The first section presents an overview of the three crisis cases, discussing both how each crisis evolved and how the IMF became involved. Next, a broad assessment of the role of the IMF in each crisis management is provided. The discussion then summarizes the main findings of the report on precrisis surveillance, followed by a summary assessment of the IMF's crisis management strategy, which typically consisted of macroeconomic policies, official financing, and structural reforms. Commonalities and differences in the three crises that come out of the evaluation are examined together with a brief summary of the report's recommendations. Finally, the discussion concludes with a summary of the Executive Board discussion on the IEO recommendations.

## **An Overview of the Three Crisis Cases**

### **Indonesia**

The crisis began in July 1997 with contagion from Thailand putting pressure on the rupiah.<sup>5</sup> On July 11 the central bank, Bank Indonesia, surprised the markets by widening the intervention margins of the crawling peg exchange rate regime from 8 to 12 percent. Speculation continued, however, and the authorities responded by tightening liquidity, raising interest rates, and intervening in the foreign exchange market. In mid-August, Bank Indonesia decided to float the currency, a step that the IMF strongly endorsed.

Following the float, Bank Indonesia raised the interest rate on 90-day central bank certificates to 28 percent from 11.25 percent and also tightened liquidity by transferring a large amount of public sector deposits out of commercial banks. In early September the government announced a delay in infrastructure projects with a total cost of US\$13 billion. Despite these measures, the exchange rate continued to depreciate and moved beyond Rp 3,000 per U.S. dollar, more than

20 percent below the average value for the first six months of the year.

Worried by these developments, the Indonesian authorities opened discussions with the IMF in mid-September 1997 on economic policy measures to restore confidence. On their way to the IMF Annual Meetings held in Hong Kong SAR in October, the First Deputy Managing Director and a senior staff member stopped in Jakarta to visit the economic team and President Suharto. The economic team saw some worrying parallels to Thailand and hoped that an IMF-supported program would help to push decisions on dealing with the troubled banks and also to accelerate structural reform in the areas that the team felt were important and that IMF surveillance had earlier identified as needing correction.

### ***The November 1997 Program***

During October the IMF negotiated a 36-month Stand-By Arrangement for about US\$10 billion, which was approved by the Executive Board on November 5. Disbursements would be front-loaded, with two tranches of US\$3 billion each by the end of March 1998. The program also assumed US\$8 billion in lending from the World Bank and the Asian Development Bank. A press notice also made a reference to the availability of additional financing from bilateral sources, if required, without including it in the headline figure.

Continuation of the tight monetary policy already in place, combined with limited foreign exchange market intervention, was expected to bring about an appreciation of the rupiah to a range of Rp 3,000–3,500 per U.S. dollar, compared with the average of about Rp 3,600 per dollar over the period of the negotiation and about Rp 2,400 per dollar for the first six months of the year. Because of the staff assessment that the problems in the private banking system were limited to a small segment, the program did not include a comprehensive bank restructuring strategy. Only 16 of the most troubled banks—accounting for 3 percent of total banking sector assets and including 3 banks connected with the president's family—were closed, with a partial deposit guarantee.



The initial market reaction was positive. The rupiah strengthened strongly in the first two days after the program was announced, in part owing to coordinated foreign exchange market intervention with Japan and Singapore, but this rise was short-lived. Public confidence was undermined when the president's family publicly challenged the bank closure and one of Suharto's sons effectively reopened his closed bank by transferring assets to another bank he had acquired.

### *The Changing Crisis*

By the end of December it was evident not only that the IMF-supported program had failed but also that the crisis in Indonesia was much worse than those elsewhere in the region. The rupiah had depreciated beyond any of the East Asian currencies that experienced regional contagion and was continuing to fall.

Recognizing the ongoing decline in economic activity, the revised January 1998 program relaxed the fiscal targets for the 1998/99 budget from the surplus of 1.3 percent of GDP envisaged in the November 1997 program to a deficit of 1 percent. The revised program also included a much more detailed structural reform agenda, with a specific timetable for implementation. But the revised January program never went forward.

The April 1998 program differed from the January program in two respects. The fiscal stance was substantially more relaxed, since by then the extent of output collapse was more evident. There was also a major change in the monetary stance. Interest rates were raised sharply for the first time since the start of the IMF's involvement. Monetary control was regained, as troubled banks were taken over, thus limiting the provision of Bank Indonesia liquidity support. Real interest rates remained negative, however, as inflation continued to soar. The IMF switched its performance criterion for monetary policy from base money (with partial adjustment for reserve loss) to a more conventional target for net domestic assets in order to better control liquidity support.

However, political developments soon came to a boil, as fuel price increases introduced in early May—against the IMF advice of gradual adjustment—sparked civil unrest. This ultimately led to the resignation of President Suharto on May 21. Vice President Habibie

took over the presidency in accordance with the Constitution, and he maintained continuity by retaining the Economic Coordinating Minister, who was responsible for implementing the IMF-supported program. The rupiah continued to depreciate through June 1998, reaching Rp 15,250 per U.S. dollar, but it began to strengthen thereafter, and inflation began to stabilize.

A new program was negotiated with the government of President Habibie in August 1998, supported under the Extended Fund Facility. The 26-month Extended Fund Facility arrangement covered the remaining undrawn amount under the initial Stand-By Arrangement, equivalent to US\$6.3 billion. The authorities took decisive measures to deal with the banking sector problems and successfully secured relief for the corporate sector from foreign creditors and a rescheduling of external public sector debt through the Paris Club.

The policies adopted after the spring of 1998 brought Indonesia back from the brink of hyperinflation and led to a significant appreciation of the rupiah. But progress was uneven, and bank and corporate restructuring proved difficult, owing to the continuing influence of powerful vested interests. Output continued to contract until the second half of 1998, primarily because of a collapse in private investment.

## **Korea**

Two events in October 1997 transformed growing unease about Korea into a full-fledged crisis.<sup>6</sup> One was the bankruptcy and government-supported debt rescheduling of the Kia Group. Investors, particularly inside Korea, perceived the authorities' actions as excessively interventionist and, in view of the approaching presidential elections in December, politically motivated. This dented confidence in the authorities' ability to pursue sound reform-oriented policies and to avoid potentially huge exposures to other troubled conglomerates.

The second event was the failed speculative attack on the Hong Kong dollar and the dramatic decline in the Hong Kong stock market at the end of October. These events accompanied an increase in the

perceived riskiness of Korea in the eyes of many international investors, particularly bank lenders. The Korean stock market fell by more than a quarter in the month of October, and the won came under increased pressure.

The authorities reacted by supporting the won through intervention in the spot and forward foreign exchange markets in the early weeks of November and by moderately increasing overnight interest rates (from about 13.5 to 16 percent). The Bank of Korea accelerated its advances of foreign exchange to banks' overseas branches. Despite these efforts, the won weakened further. An increasing number of foreign banks chose not to roll over their short-term loans to Korean institutions and instead reduced their credit lines. The maturity of existing lines was shortened, and interest rates on longer-term loans were raised.

Faced with the rapid depletion of foreign exchange reserves, the authorities quietly contacted officials from the United States, Japan, and the IMF in an attempt to secure emergency financing. At the authorities' request, the Managing Director of the IMF secretly visited Seoul for discussions with the Minister of Finance and Economy and the Governor of the Bank of Korea on November 16.

The IMF team that arrived in late November had planned to conclude a Stand-By Arrangement by around mid-December, but they found that the position was much worse than it had appeared. Official foreign exchange reserve figures included advances to the overseas branches of Korean institutions and were highly illiquid. Korea's "usable reserves"—calculated by excluding deposits in overseas bank branches—were only around US\$7 billion, which was very small in relation to maturing short-term debt and other obligations. Unless new financing was provided quickly, Korea might have to impose a standstill on foreign exchange payments, a move that staff, management, and key shareholders feared would have serious regional and international implications. The program was negotiated and agreed to in record time, under the exceptional procedures of the Emergency Financing Mechanism.

### ***The December 1997 Program***

On December 4, the IMF's Executive Board approved the provision of about US\$21 billion to Korea under a three-year Stand-By Arrangement. The disbursements were to be substantially front-loaded. In addition, the World Bank and the Asian Development Bank were to lend US\$14 billion in support of restructuring efforts in the financial sector, and a group of bilateral donors indicated that, if necessary, they would be willing to lend a further US\$20 billion as a "second line of defense."

The second line of defense was a controversial element in the program. The balance-of-payments projection in the approved program did not actually show that this financing would be necessary. But this presentation was a relatively late decision responding to the instructions conveyed to IMF staff that the program should not rely on this source of financing. The staff therefore arbitrarily reduced the projected financing gap by increasing the assumed rollover rate for short-term debt to unrealistically high levels. In this respect, the program as presented was clearly underfinanced, although this fact was not explicitly acknowledged.

The program incorporated a tight monetary policy; a small fiscal surplus; a comprehensive strategy to restructure, recapitalize, and reform the financial sector; and measures to reform corporate governance, trade, and the labor market. Nine of the most troubled merchant banks were closed, with their depositors protected by a recently established deposit insurance scheme.

The initial market response was moderately positive, but after a few days the situation took a turn for the worse. Confidential program documents, leaked to the Korean press, revealed the critical data on Korea's reserves and short-term debt, which the IMF and the authorities had been keeping from the markets for fear of damaging confidence. The documents showed that usable reserves were even lower than the market had feared and were declining rapidly. The political environment also created uncertainty since elections were being held. As the market absorbed these developments, rollovers of short-term debt continued to fall, and the won weakened further, falling by 39 percent in the two weeks after the program was approved.

After winning the presidential election on December 18, President-elect Kim Daejung announced his determination to carry out the IMF-supported program, and his subsequent actions helped build credibility.

### ***The Rollover Agreement***

Three initiatives—a strengthened reform program, accelerated disbursements, and a coordinated private sector rollover of short-term debt—were announced on December 24. The IMF played a useful role in the more concerted approach to maintaining private sector exposure by setting up systems to monitor daily exposure and facilitating information exchange among the major governments.

Markets remained volatile for several weeks thereafter but, in retrospect, December 24 proved to be the turning point of the Korean crisis. The international banks by and large kept to their rollover agreement, which was renewed in mid-January and extended to the end of March. Shortly thereafter, the banks agreed to exchange their short-term claims for sovereign debt of between one and three years maturity. With the success of the rollover and maturity extension and moves by the authorities to implement the financial and corporate reform programs, the market's view of Korea improved dramatically. The IMF facility would never be fully drawn and would eventually be paid back ahead of schedule.

The macroeconomic effects of the crisis turned out to be severe but short-lived. Real GDP declined by 6.7 percent during 1998, and unemployment rose to 7.4 percent by year end. Yet signs of recovery were already visible by the end of 1998, and growth rebounded to 10.9 percent in 1999, belying fears expressed by many that the recovery would be L-shaped. The authorities moved quickly to rebuild reserves, which totaled US\$52 billion at the end of 1998. Following the peak in early 1999, unemployment began to decline steadily, and growth of real wages picked up strongly.

### **Brazil**

After mid-1997, turbulence in the global economy and presidential election politics limited the options of the Brazilian government in addressing fiscal and exchange rate issues.<sup>7</sup> Following the onset of

the Asian crisis in the fall of 1997, the Brazilian real came under intense pressure, prompting the authorities to raise interest rates to defend the exchange rate and to intervene heavily in the spot and futures exchange markets.

Early 1998 saw strong capital inflows, including foreign direct investment and short-term flows attracted by the opportunity to arbitrage between high domestic and low international interest rates, given the widespread presumption that the crawling peg would be maintained at least until the presidential election in October. In the summer, market pressures on Brazil greatly intensified, following the Russian crisis and the difficulties of Long-Term Capital Management in the United States, which led to a sharp decrease in liquidity in international capital markets. Spreads on Brazil's external debt rose steeply along with those for most other major emerging market borrowers. The central bank doubled interest rates in early September but failed to stem capital outflows.

### ***The December 1998 Program***

Preliminary work began on the main components of an IMF-supported program in early September 1998, based on Brazilian proposals emphasizing fiscal tightening. The pace of negotiation for a program picked up following the presidential election in October, and the program was approved by the Executive Board in early December.

The December program envisaged maintenance of the existing crawling peg exchange rate regime, but did not specify any immediate change in the rate of crawl. The possibility that exchange rate policy might be modified at subsequent program reviews was left open. The program included strong, front-loaded fiscal adjustment (amounting to over 4 percent of GDP) and a commitment to supportive monetary policy. Conditionality on structural measures was limited mainly to critical areas in public finance and prudential regulation in the financial sector.

### ***Collapse of the Peg and the Revised March 1999 Program***

The IMF's decision to support the crawling peg involved significant risks. The business community was not entirely in favor of the peg and had been putting pressure on the president to correct the overvaluation of the currency. Moreover, the IMF decision did not fully impress the markets. General skepticism prevailed in the media coverage of the IMF decision.

Soon after the program was approved and announced to the public, the exchange rate came under new pressure following setbacks in securing congressional approval for some of the fiscal measures in the program. Interest rates were also eased despite IMF misgivings and contrary to an understanding that there would be consultation with the IMF on interest rate policy. Fiscal tensions between the federal government and the states surfaced, and in early January 1999 the governor of the state of Minas Gerais stated publicly that there would be a moratorium of 90 days on state debt payments.

In mid-January 1999 a new central bank governor introduced a complex exchange rate system incorporating a wider exchange rate band in an attempt at a smooth exit from the crawling peg. After losing about US\$14 billion of reserves in two days, Brazil moved to a de facto floating exchange rate regime on January 15. The collapse of the peg signaled that the original program had clearly failed in its central objective. In an emergency weekend meeting between the Brazilian economic team and IMF management in Washington, it was decided that the best policy was to float the real, effective January 18. Both sides then began to revise the program in light of the change in the exchange rate policy. To arrest and reverse the depreciating trend, the IMF encouraged the central bank to raise interest rates sharply. An increase in interest rates to nearly 40 percent at the start of February was followed by a further increase in the overnight rate to 45 percent in March.

A revised program was agreed to in March 1999. The new program, which pioneered the use of inflation targeting as the basis for conditionality in IMF-supported programs, also tightened fiscal policy further, with the aim of ensuring debt sustainability. The indicative target of 2.6 percent of GDP for the primary balance in 1999 was replaced by a target of 3.1 percent as a performance criterion in the

revised program. Major international banks voluntarily agreed to maintain trade and interbank lines to Brazil at end-February levels for six months. Against the background of high interest rates, stepped-up sales of foreign exchange in the market, and greater market confidence generally, the exchange rate stabilized. This allowed interest rates to be eased relatively quickly. Progress was also made on structural reforms, although the pace was slower than envisaged in the program.

The revised program of March 1999 was unexpectedly successful in its impact on prices and output. A takeoff in inflation, greatly feared following the depreciation, was averted, and consumer price inflation was held at 9 percent during 1999. Stronger-than-expected external financing, particularly larger inflows of foreign direct investment, facilitated a smoother external adjustment. In contrast to pessimistic projections of a decline in GDP of 3.8 percent in 1999, real output grew by 0.8 percent. The financial sector weathered the crisis well, in part owing to the extensive hedge against depreciation provided by the public sector, which also bore the brunt of temporarily increased interest rates.

Given strong ownership by the authorities, sharply higher primary fiscal surpluses were achieved in line with program targets. The financial support package was largely repaid ahead of schedule, and the arrangement was treated as precautionary from March 2000 onward. But the program did not achieve its central declared aim of reducing the ratio of net public debt to GDP, in large part owing to the greater-than-expected depreciation of the currency, which increased the domestic currency value of external and foreign currency-linked domestic debt.

### ***Program Outcomes***

While the public image of the December 1998 program is largely colored by its failure to defend the crawling peg, the IMF's overall strategy can be judged to have been a success in many respects. Contrary to the program's own pessimistic expectations, the adverse impact of the crisis on output and prices was limited. Through the program, which was revised to take account of the floating of the real, the IMF facilitated Brazil's transition to a more disciplined fiscal regime and a new monetary regime based on inflation targeting.



One aspect of the December program, however, proved to be a source of later vulnerabilities: it maintained the large transfer of exchange rate risk from the private to the public sector, which had resulted from issuing a large amount of foreign currency–linked debt. The central declared objective of fiscal adjustment—to reduce the ratio of public debt to GDP—was undermined by the large fiscal cost of providing this hedge and defending the crawling peg. The exchange rate depreciated more than anticipated, while the IMF’s efforts to encourage the authorities to reduce the proportion of exchange rate–linked debt had limited impact.

## **The Role of the IMF**

### **Indonesia**

IMF surveillance did identify the vulnerabilities in the banking sector that would later become crucial to the evolution of the crisis, but it underestimated their severity and the potential macroeconomic risks they posed. In designing a crisis management strategy during October 1997, the IMF did not pay enough attention to some critical aspects of ownership and underestimated the likely resistance to reform by vested interests. This underestimation of political constraints was perhaps a reflection of the earlier failure of surveillance in recognizing the changing nature of corruption and cronyism.

The principal weakness of the November 1997 program was the absence of a comprehensive bank restructuring strategy. Lack of clarity on the need to close insolvent banks led to a rapid expansion of liquidity to support weak banks. The resulting loss of monetary control in turn contributed to a weaker exchange rate and greater distress in the corporate sector. Contrary to the views of many external commentators, the tight monetary policy recommended by the IMF was not a cause of the subsequent recession—because such a policy was not implemented. The crisis became intensely political following the illness of the president in early December, making crisis management even more difficult.

The IMF negotiated a revised program in January 1998, which focused heavily on structural conditionality to signal a clean break from the past. The focus on structural conditionality was based on the assumption that this was necessary to restore confidence. It failed to do so, partly because of a visible lack of political commitment to the policies promised and partly because of the failure to address the critical banking and corporate debt problems.

The Indonesian crisis was clearly the most severe of the three, with a 13 percent decline in GDP in 1998 and a large increase in poverty. This devastating outcome cannot be attributed solely to shortcomings of the IMF. The lack of firm implementation of the November program, especially the reversal of some critical steps at a very early stage, eroded market confidence. And the situation soon got out of control as political uncertainty increased and riots occurred against the ethnic Chinese community. These exceptional circumstances explain much of the severity of the crisis in Indonesia. But the IMF's response to the failure was also inadequate in many respects.

## **Korea**

In Korea, IMF surveillance failed to adequately identify the risks posed by the uneven pace of capital account liberalization and the extent of banking sector weaknesses, owing to the reliance on a conventional approach that focused on macroeconomic variables. There were gaps in the data needed to make a full assessment, but available data on short-term debt and financial market indicators were not fully used. Concerns over Korea's weak banking sector had prompted international banks to review their lending to some Korean institutions even before the onset of the Asian crisis in July 1997, but the IMF was optimistic until virtually the last minute.

The first Korea program was clearly underfinanced, but this was due primarily to the unwillingness of major shareholder governments either to take concerted action to involve the private sector or to provide the necessary financing up front to resolve what was, of all the three cases, most clearly a liquidity crisis. When this strategy failed, the major shareholder governments moved quickly to facilitate a coordinated rollover and maturity extension of private sector claims—an approach that contributed to a rapid restoration of market confidence.

It could be argued that the first strategy needed to be tried and proven to have failed before the rollover agreement of December 24 could be secured. The IMF played a useful role as crisis coordinator in facilitating information exchanges among major governments and helping to set up a monitoring system to ensure compliance, but it could have signaled more forcefully that the first program was unlikely to succeed.

The Korean adjustment process involved a severe downturn, with GDP declining by 6.7 percent in 1998, compared with a forecast of positive growth. But unlike in Indonesia, this was followed by a robust recovery in 1999. The greater-than-expected downturn reflected the impact of negative balance-sheet effects, which were clearly underestimated. In retrospect, the fiscal tightening in the program was unnecessary, as the IMF staff has itself concluded, but this was not a major cause of the recession and was quickly reversed.

## **Brazil**

In Brazil, IMF surveillance was successful in identifying the key vulnerabilities that were at the core of the crisis, in part owing to the fact that they were largely macroeconomic in nature. But it progressively downplayed the scale of overvaluation and had little impact in persuading the Brazilian authorities to take sufficient corrective action even in areas where the diagnosis was correct. When Brazil faced intense speculative pressure on its foreign exchange reserves from mid-1998, the IMF reluctantly supported the authorities' preference for maintaining the existing crawling peg exchange rate regime. However, intense pressure on the real developed, and the program soon failed with the collapse of the peg in January 1999.

A major justification for maintaining the exchange rate regime was that an exit from the peg at that time would have unsettled international financial markets already nervous after the Russian default and the Long-Term Capital Management crisis. With the benefit of hindsight, this concern was overplayed. An earlier exit from the peg, widely perceived to be unsustainable, probably would not have had major systemic effects if it had been made under an IMF-supported program. The hedge provided to the private sector by the government, through the use of foreign exchange reserves and exchange rate-indexed bonds, ensured that the sharp depreciation that followed the

floating of the real in January 1999 had little adverse effect on the Brazilian economy. But this was at the cost of a substantial increase in the stock of public debt and was against the spirit of IMF advice.

The revised 1999 program fared fairly well in the short run. Contrary to program expectations of negative growth in 1999, Brazil actually experienced positive growth of 0.8 percent. This was largely because of the healthier state of the banking system, combined with the provision of the hedge, which mitigated balance-sheet effects on the private sector. The IMF played a useful role in facilitating Brazil's transition to an inflation-targeting monetary regime as well as a more disciplined fiscal policy regime. Although implementation of structural reforms was mixed, the Fiscal Responsibility Law made a significant contribution to achieving higher fiscal surpluses. But in retrospect, fiscal vulnerabilities were not fully eradicated.

### **Precrisis Surveillance**

The effectiveness of IMF surveillance during the precrisis period varied in the three countries. Surveillance identified the central problems in Brazil reasonably accurately, but it was much less effective in Indonesia and Korea. It identified specific weaknesses in these countries, but underestimated their seriousness and thereby failed to provide sufficient warning. This difference in effectiveness partly reflected the fact that Brazil suffered primarily from macroeconomic imbalances, a conventional focus of IMF surveillance, whereas in Indonesia and Korea the critical problems lay in weaknesses in the financial and corporate sectors.

IMF surveillance identified these weaknesses, but it did not produce an accurate assessment of the extent of the vulnerabilities they posed. Surveillance reports were insufficiently candid about potential vulnerabilities, especially those related to governance issues. In part, these problems reflected weaknesses in data availability that subsequent initiatives have attempted to correct, but they also reflected internal incentives that discouraged candor. More generally, there was insufficient appreciation of the fact that weak balance sheets can pose substantial macroeconomic risks, even when most macroeconomic indicators suggest no obvious major problems.

IMF surveillance was more successful in identifying macroeconomic vulnerabilities than in recognizing and analyzing in depth the risks arising from financial sector and corporate balance-sheet weaknesses and the governance-related problems that contributed to those weaknesses. Insufficient candor and transparency limited the impact of surveillance on policy, even in areas where the diagnosis was broadly accurate.

In Indonesia, the IMF did identify banking sector weaknesses as a problem, but surveillance reports underestimated the potential adverse macroeconomic consequences of these weaknesses. Surveillance also paid insufficient attention to the changing nature of corruption and the macroeconomic risks it posed, and surveillance reports were less candid on these issues.

In Korea, the IMF failed to adequately recognize the vulnerabilities created by the uneven sequence of capital account liberalization and the risk that a change in investor sentiment could cause a severe drain on foreign exchange reserves. While the crisis also came as a surprise to many other observers, the IMF was slow to catch the rising concerns of international banks over Korea's banking sector problems, which had begun to surface several months before the onset of the full-blown crisis. In retrospect, surveillance proved too sanguine about these growing risks.

IMF surveillance effectively diagnosed the major vulnerabilities in Brazil, largely because the economy's vulnerabilities manifested themselves primarily as macroeconomic phenomena, such as the rising stock of public debt and real exchange rate appreciation, which were part of the IMF's traditional toolkit.

In all three countries, the IMF's role as confidential advisor was not very effective in persuading countries to modify their policies even when key vulnerabilities were identified. In some cases, the IMF was not provided with sensitive information required for effective surveillance. It is difficult to generalize from three cases, or to test the counterfactual concretely, but the IMF probably could have been more effective in influencing policy if it had made its analyses public so as to contribute to a wider policy debate.

Even where vulnerabilities were identified, the IMF's surveillance in the period leading up to the crisis tended to have little practical influence on critical policies and was generally not successful in promoting remedial action to address these vulnerabilities. This should not necessarily be interpreted as a shortcoming. As previous internal and external reviews have noted, IMF surveillance is only one influence on economic policies in member countries, and generally not the predominant one. While it is too much to expect IMF surveillance to achieve more than it is capable of doing, evidence from the three case studies suggests that at least four factors contributed to the limited impact of surveillance.

First, surveillance suffered from a reluctance to be candid in stating difficult or embarrassing facts and views, for fear that this would alarm the markets or generate conflict with national authorities. There were a number of occasions when important concerns were raised in internal documents or during the internal review process, but these issues were not adequately reflected or were discussed only in an oblique manner in the documents later prepared for the Executive Board. Even if members of the staff or the Board knew of and discussed these issues off the record, the fact that these discussions were not contained in written reports hindered effective diagnosis and decision making and made it difficult to transfer country-based knowledge among staff members.

Second, in some cases country authorities were not receptive to the IMF's policy advice, typically reflecting domestic political constraints (as in the case of deregulation in Indonesia). When an issue of a highly sensitive nature was involved, such as exchange rate policy in Brazil, there were honest differences of view.

Third, the impact of IMF advice was necessarily limited when no program was involved. This meant that the IMF's influence was particularly limited by the general strength of capital flows to emerging markets in the period preceding the crises. The IMF's views did not figure strongly until the crises were at hand.

Finally, information weaknesses affected not only the quality of surveillance, but also its impact. As a 1999 review of surveillance by an IMF-commissioned group of outside experts noted,<sup>8</sup> the absence of hard numerical evidence on financial sector weaknesses, reserves, and

external debt limited the staff's ability to make a forceful case to the authorities about the vulnerabilities in Korea. The same also applied to Indonesia, particularly in the area of banking data.

## **Program Design for Crisis Management**

### **Macroeconomic Framework and Projections**

In all three cases, macroeconomic outcomes turned out to be very different from program projections. In Indonesia and Korea, the initial projections were overly optimistic, leading to the design of macroeconomic policies that turned out to be too tight given the outcome in aggregate demand and output. In contrast, the initial projections for Brazil in 1999 were too pessimistic, which contributed to fiscal adjustment that turned out to be insufficient, in light of that country's adverse public debt dynamics.

Part of this problem arises because macroeconomic projections in an IMF-supported program are necessarily the outcome of negotiation. Moreover, forecasts were not derived from an analytical framework in which the key determinants of output, and their likely behavior during the crisis, could be dealt with adequately. In particular, there was insufficient appreciation of the large currency depreciation that might occur in view of the possibility of multiple equilibria, and the severe balance-sheet effects that might result.

It is inherently difficult to forecast macroeconomic outcomes reliably, especially in a crisis situation. But these problems could have been reduced if there had been a more explicit focus on the key factors affecting aggregate demand, particularly private investment.

In light of the considerable uncertainties, a more explicit discussion in program documents of the major risks to the macroeconomic framework, with a clear indication of how policies would respond if the risks materialized, would have been helpful. In practice, program reviews on Indonesia and Korea did show flexibility, but an up-front recognition of risks and identification of alternative policy responses would have sent a more transparent signal on the expected stance of policies.

## **Fiscal Policy**

All three programs initially involved fiscal tightening. The tightening was mild in Indonesia and Korea, while fairly strong in Brazil. In view of output developments and the low level of government debt, tightening of fiscal policy in Indonesia and Korea was not warranted, and it was in fact relaxed when the extent of output collapse became evident. In any event, in neither country was the initial fiscal tightening the cause of the output collapse. This was the result of balance-sheet effects, which were not factored into program design. In Brazil, fiscal tightening was much sharper. This was appropriate because debt sustainability was a major issue driving the evolution of the crisis. However, it turned out to be insufficient to achieve the objective of stabilizing, and then reducing, the debt-to-GDP ratio.

## **Monetary Policy**

The stance of monetary policy in all three countries was initially set tight, with an explicit recognition of the trade-off between higher interest rates and a weaker exchange rate. But the experience of the three countries varies and does not provide a definitive answer to the ongoing debate on the effectiveness of high interest rates in stabilizing the exchange rate.<sup>9</sup>

In Indonesia, the maintenance of tight monetary policy envisaged in the program was simply not implemented, as the monetary base expanded rapidly and real interest rates became increasingly negative during the early months of the program. The assertion by some critics that the tight monetary policy advocated by the IMF was a cause of the output collapse is not warranted for the simple reason that it was not implemented for most of the crisis period. Exchange rate stability returned in March 1998, when the rupiah had sufficiently depreciated and interest rates were raised and monetary control was regained.

In contrast, Korea implemented the tight monetary policy envisioned in the initial program by raising domestic interest rates and the penalty rate charged to banks for central bank foreign currency advances. These moves were appropriate to defend the currency, but they were not by themselves sufficient to stabilize the exchange rate, because much of the capital outflow was driven by



credit considerations rather than yield. It can be argued that real interest rates were kept higher than might have been necessary in early 1998, when the exchange market had stabilized. But the still uncertain situation understandably called for some caution. Given the contractionary impact of bank restructuring on credit flows, the few months of higher-than-necessary interest rates could not have been the dominant cause of the recession.

In Brazil, the excessive easing of interest rates—over the IMF’s objections—may have contributed to the timing, if not the eventuality, of the collapse of the crawling peg. A decisive tightening of monetary policy in March 1999 coincided with the restoration of stability in the foreign exchange market. However, one must be careful about the causality, given the fact that an informal agreement by major international banks to maintain credit lines to Brazil was reached around the same time. High interest rates did not have a major negative impact on the private sector, because of the relatively sound state of the banking system and the relatively low leverage of the corporate sector, compared with the situations in Asia. Subsequently, the IMF supported Brazil’s transition to an inflation-targeting regime, which allowed for price stability and a rapid reduction in interest rates.

### **Size of Official Financing**

The size and format of the official financing package were inadequate in Korea and contributed to the failure of the first program. The ambiguity over the availability of US\$20 billion in bilateral assistance pledged as a “second line of defense” in Korea created uncertainty in the market about the ability of the program to meet the country’s immediate liquidity needs.

In the other two countries, the programs failed for other reasons. The failure of the initial Indonesian program was due not to inadequate financing but to other factors, including non-implementation of the key elements of the program by the authorities and the subsequent explosion of liquidity. Once the program had failed, the crisis became intensely political, leading to a large amount of capital flight by domestic residents, and the sharp depreciation of the rupiah began to create solvency concerns. No reasonable amount of official financing could have restored confidence at that time. In Brazil, the initial pro-

gram failed because the key policy—supporting the crawling peg exchange rate regime—was not credible to the markets.

### **Private Sector Involvement**

In Korea, the IMF's role as crisis coordinator in organizing private sector involvement (in a burden-sharing arrangement with the official sector) was limited in the early stages of the crisis by the unwillingness of major shareholder governments to use nonmarket instruments to influence the behavior of private sector institutions, and by concerns that such action might precipitate an exodus of capital from emerging markets. However, once a decision was made by the major shareholders to involve the private sector in maintaining exposure, the IMF played a useful role in facilitating information exchange among major governments and helping to set up systems for monitoring compliance.

Given the initial unwillingness of the IMF's major shareholder governments to take concerted action, there was probably little the IMF could do. The agreement by major international banks to roll over interbank debt on December 24, 1997 was a turning point in the Korean crisis. The success of this approach owed much to the fact that most of the short-term external debt was interbank credit. An earlier attempt to involve the private sector in Korea would have been warranted.

The Brazilian experience in the second program suggests that a program with a high degree of credibility is necessary for the "voluntary" approach to private sector involvement to work. Not until the peg was abandoned and the new IMF program applied inflation targeting as the basis of conditionality did international banks agree to maintain trade and interbank lines to Brazil for at least six months. Once the agreement was made, the IMF played a useful facilitating role. In Indonesia, the IMF provided technical assistance for corporate debt restructuring, but its role was limited.

## **Bank Closure and Restructuring**

The experiences of Indonesia and Korea suggest that a successful bank closure and restructuring program must include a comprehensive and well-communicated strategy in which transparent rules are consistently applied.<sup>10</sup> The Korean program by and large achieved its objectives, mainly because a comprehensive strategy was developed at the outset.

The Indonesian banking sector program, by contrast, initially suffered from the lack of a comprehensive strategy and the failure to communicate the logic and outline of the policy to the public. So the closure of 16 banks in November 1997, with subsequent reversals, exacerbated rather than dampened the crisis. The bank closures in Indonesia in April 1998 were more successful because they were part of a comprehensive strategy that was well communicated to the public and based on the consistent application of uniform and transparent criteria.

Whether a blanket guarantee, instead of the partial guarantee actually offered, should have been introduced in Indonesia in November deserves careful consideration. The evaluation suggests that the banking crisis was not yet systemic in November, so that the partial guarantee was appropriate. In the end, the blanket guarantee introduced in January was subject to abuse and consequently raised the fiscal cost of bank restructuring. The problem in bank restructuring was more with the initial lack of a comprehensive and well-communicated strategy than with the nature of the guarantee.

## **Structural Conditionality**

All three programs involved structural conditionality, but the experience with conditionality was very different. The Indonesian and Korean programs were characterized by extensive structural conditionality (especially the January 1998 Indonesian program) covering several areas that were not macro-critical. The scope of structural conditionality in the Brazilian program was limited to structural fiscal reform and prudential regulation. Part of this difference reflected the absence in Brazil of many of the distortions that had been present in Asia.

Measures to rehabilitate and reform the financial sector were necessary in both Indonesia and Korea and were appropriately included in the programs. In Indonesia it was also important to tackle corporate restructuring, including by reforming the legal system, but this element was missing in the first two programs. As for the various nonfinancial structural reform measures included in the Indonesian and Korean programs, many of these may have been beneficial in improving long-run economic efficiency, but they were not necessary as part of the immediate crisis resolution.

In Indonesia, many governance-related measures were included in the January program at the urging of some of the IMF's major shareholders in the belief that confidence could be restored only by signaling a clean break with the past. But the evaluation suggests that the proliferation of nonfinancial structural conditionality led to a loss of focus on critical reforms in the banking sector, which was more important for restoring stability. Proliferation of structural conditionality may also have led to lack of ownership at the highest political level and non-implementation, both of which damaged confidence.

### **Communications Strategy**

A program for restoring confidence must include a strategy to communicate the logic of the program to the public and the markets, in order to enhance country ownership and credibility. None of the three programs initially contained such a strategy. Effective public communications are essential to build broad support for the program. Likewise, effective dialogue with the markets would improve program design through understanding the expectations of market participants, and also help build credibility for the program. It is important for the IMF to explain clearly the logic and strategy of the program, including spelling out the major risks, with a broad indication of how policies would respond to them.

### **Commonalities and Differences in the Three Crises**

The three cases share several features common to capital account crises. In each case the crisis occurred because of massive reversals of capital flows triggered by a shift in market sentiment. Short-term flows played a prominent role in the process, and contagion was an

important factor. All three crises led to IMF-supported programs involving large amounts of IMF resources, supplemented by those of bilateral agencies and other sources.

In Indonesia and Korea, IMF surveillance failed to signal alarm because the crisis occurred against the background of sound macroeconomic fundamentals, including good export growth performance, relative price stability, and broad fiscal balance. There were vulnerabilities in both cases in the form of financial sector weaknesses, highly leveraged corporate balance sheets, weak public and corporate sector governance, and rising short-term unhedged external indebtedness. These potential vulnerabilities were identified in varying degrees in IMF surveillance. But their seriousness and implications were not adequately appreciated, because the vulnerabilities were rooted in the private sector and the financial system in particular, not yet core areas of IMF surveillance. The fragile financial sector in both Indonesia and Korea meant that the crisis in each case was a “twin crisis,” with a balance-of-payments crisis taking place at the same time as a banking crisis.

Brazil, by contrast, showed clear evidence of critical macroeconomic imbalances—a chronic deficit in the fiscal account, rising public sector debt, and real exchange rate appreciation. The IMF’s surveillance was much more effective in identifying these vulnerabilities because they were rooted in macroeconomic policies and the public sector, areas of conventional focus. Unlike in Indonesia and Korea, banking sector weakness was not a serious problem in Brazil at the time of the crisis.

All three countries experienced sharp declines in currency values, but the fall of the Indonesian rupiah far exceeded that of either the Korean won or the Brazilian real, reflecting the exceptional nature of the Indonesian crisis. Output fell sharply in Korea and even more so in Indonesia, where there was also a significant increase in the incidence of poverty. While in Korea there was a strong rebound in the second year following the crisis, in Indonesia the recovery was delayed and in some ways has not yet been fully achieved. Brazil weathered the crisis better than expected, with the economy showing positive growth in the year following the crisis. But underlying vulnerabilities resulting from unfavorable debt dynamics were not eradicated, surfacing again in 2002.

The political environment in each of the three cases was also very different, and this had a profound impact on the effectiveness of crisis management in each country. In Brazil and Korea, after some initial uncertainty, there was strong political commitment to the program, which helped to achieve credibility. In Indonesia, on the other hand, the economic crisis was compounded by an evolving political crisis, rendering crisis management ineffective.

### **IEO Recommendations**

Since the three crises, the IMF has taken many initiatives to strengthen its surveillance and program design.<sup>11</sup> Many of the weaknesses in surveillance and program design identified here have already been addressed by the IMF in its revised policies and procedures. Even so, continued efforts would be necessary in several areas in order to further enhance the IMF's effectiveness in surveillance and crisis management. The evaluation report made the following recommendations.

#### **Take a Stress-Testing Approach**

Article IV consultations should take a "stress-testing" approach to the analysis of a country's exposure to a potential capital account crisis. The current guidelines, revised in September 2002, already suggest that surveillance should include "comprehensive assessments of crisis vulnerabilities," covering "economic fundamentals that may have an impact on market sentiment," "risks arising from global market developments," and "factors affecting a country's ability to deal with a sudden shift in capital flows." This approach should be extended and systematized.

Reports for Article IV consultations could itemize the major potential shocks that the economy could face in the near future, explore the likely real and financial consequences of each of these shocks—including balance-sheet effects—and discuss the authorities' plans for dealing with them.<sup>12</sup> Such discussion should cover the effectiveness of any existing social safety nets both as automatic fiscal stabilizers and as a means of mitigating the impact of a crisis on the most vulnerable groups in society.

To develop a greater understanding of the political constraints that may affect policymaking, Article IV consultation missions should seek a wider dialogue with individuals beyond senior economic officials, especially those in the domestic and international financial communities.

### **Make Surveillance Assessments Candid and More Public**

The IMF should take additional steps to increase the impact of surveillance, including making staff assessments more candid and more accessible to the public. The recently revised surveillance guidelines call for Article IV consultation reports to contain a more systematic assessment of what happened as a result of the IMF's previous policy advice (along with an opportunity for the authorities to comment on the advice). To make such assessments more operationally relevant, the IMF could develop escalated signaling procedures when key vulnerabilities are not addressed over several rounds of surveillance.

The IMF should also explore the possibility of seeking "second opinions" from outside the IMF when the authorities disagree with the staff's assessment on issues that are judged to be of systemic importance. This would improve the objectivity of handling contentious issues in the surveillance process and perhaps enhance its impact. It would also serve as a building block for escalated signaling.

Reports for Article IV consultations should be published to generate a more informed debate on the need for structural reforms oriented toward crisis prevention. The public would also be better informed about the underlying rationale of the reforms that the IMF might subsequently deem necessary in the event of a program. Encouraging publication of country-level analytical work by staff would also contribute to the quality of IMF advice and public policy debate.

### **Revisit the Design of IMF-Supported Programs**

A comprehensive review of the IMF's approach to program design in capital account crises should be undertaken. The IMF's internal reviews have already generated many important lessons for program design, and this evaluation has highlighted a number of oth-

ers. The proposed review or redesign should be oriented around two key principles:

- The interaction of balance-sheet weaknesses and key macroeconomic variables is critical to how the economy will respond.
- The overriding objective of a crisis management program should be to restore confidence.

In particular, much more attention should be paid to balance-sheet interactions and their consequences for aggregate demand, especially in capital account crises. With the associated prospect of a large change in the exchange rate, an obvious message from the case studies is that designing programs around a single real GDP growth projection, inevitably the result of negotiation, can lead to significant problems in macroeconomic program design.

Program design should also allow for a flexible response if outcomes are unfavorable. Large changes in key variables in a capital account crisis may render the original program irrelevant very quickly, and the appearance of persevering with a failed program can be damaging to market confidence. Program documents should spell out explicitly how macroeconomic policies will respond in the event of sharper-than-programmed economic downturns, and this should be clearly communicated to the public.

The conventional framework of conditionality based on financial programming should be reviewed to see if, and how, it should be adapted to the circumstances of capital account crises. It may be preferable to agree, in addition to performance criteria, to a mechanism of triggering consultations on monetary and fiscal policy, with some understanding on how the policy mix needs to change in light of evolving circumstances. Just such an approach was taken in Korea in December 1997 in the setting of interest rates and in Indonesia in March 1998 when particular interest rate actions were specified. The approach to program conditionality in countries with formal inflation-targeting frameworks for monetary policy is also evolving in this direction. However, a crisis should not be used as an opportunity to force long-outstanding reforms, no matter how desirable they may be, in areas that are not critical to the resolution of the crisis.



Finally, program design should include an agreed-upon strategy to communicate the logic of the program and any subsequent program-related information to the public and the markets. Such a strategy should be characterized by a high degree of transparency, including the immediate publication of letters of intent and early disclosure of any unfavorable information.

### **Official Financing**

Since restoration of confidence is the central goal, the IMF should ensure that the financing package, including all components, is of credible quality and sufficient to generate confidence. Financing packages prepared by the IMF should not rely on parallel official financing, unless the terms of access are clear and transparently linked to the IMF-supported strategy. Attempts to inflate the total amount of financing by including commitments made under uncertain terms would risk undermining the credibility of the rescue effort. This implies that if the IMF is to play an effective role as crisis coordinator, either it must have adequate financial resources of its own or the availability of additional official financing should be made subject to a single, predictable framework of conditionality.

When parallel financing is sought from other international financial institutions, the terms of reference for their engagement should be specified at the very outset, including mechanisms to resolve differences of opinion and to specify the manner in which their inputs are reflected in program design. This is particularly important for collaboration with regional development banks, for which no established procedures exist.

### **The IMF as Crisis Coordinator**

The IMF should play a central role in identifying circumstances where more concerted efforts (as were eventually undertaken in Korea) can be useful in overcoming “collective action” constraints. This should be based on a meaningful dialogue with the private sector,

building on the new mechanisms for such a dialogue that have been established in recent years.

### **Executive Board Discussion**

In responding to the evaluation report, both IMF management and the Executive Board expressed broad agreement with many of its conclusions and recommendations. In particular, in their discussion of the report on May 30, 2003, Executive Directors “shared the report’s view that the IMF made some mistakes, and that the crises highlighted the need for improvements in the IMF’s policies and procedures.” They “considered that the report has provided useful recommendations on how to further improve IMF surveillance and program design, and on how to enhance the catalytic role of IMF financing and the role of the IMF in coordinating crisis management and resolution.” Management and the Board indicated their intention to revisit these issues as part of the ongoing work program.

#### **On Taking a Stress-Testing Approach**

Directors agreed that it is essential to strengthen the focus and effectiveness of IMF surveillance by extending and systematizing assessments of crisis vulnerabilities. Surveillance discussions should identify major shocks that the economy could face in the near future, explore the real and financial consequences of these shocks, including balance-sheet effects, and discuss the authorities’ plans for dealing with these shocks if they materialize. Directors emphasized that within the general framework endorsed by the Board, vulnerability assessments—and particularly stress testing—should not be overgeneralized and exhaustive. They should focus on the key risks and economic realities facing the member in question. And the assumptions underlying such assessments should be set out clearly to allow a proper interpretation of the results and help inform the ranking of reforms by authorities.

#### **On Making Surveillance Assessments Candid and More Public**

Directors strongly supported greater candor in the assessment of country risks and vulnerabilities in staff reports, building on the increase in candor that has already occurred. The provision of institu-

tional incentives to the staff to facilitate such candor was also encouraged. Even so, Directors expressed a range of views about potential conflict between candor and transparency—and the implications of the proposed shift from voluntary to presumed publication of staff reports.

Many Directors warned that greater candor in published staff reports could impair market confidence and the IMF's dialogue with countries. Some felt that what really matters is candor in face-to-face consultations with the key decision makers in a country, rather than in the staff report.

### **On Revisiting the Design of IMF-Supported Programs**

Directors recognized that program design plays a critical role in the determination of program success. Directors agreed that the primary objective of a crisis management program should be to help restore confidence by implementing a comprehensive set of policies that effectively address the root causes of the crisis. Directors noted that the IMF's increased attention to financial sector surveillance has reduced the risk that vulnerabilities in the financial sector will be neglected in program design. At the same time, many Directors also concurred that much greater attention needs to be paid to the interaction of balance-sheet weaknesses and key macroeconomic variables, including the implications for aggregate demand, especially in capital account crises where the possibility of multiple equilibria exists—although it was acknowledged that the estimation difficulties may be formidable.

### **On the IMF as a Crisis Coordinator**

Directors emphasized the importance of all members working together constructively when a program is being negotiated. They noted that for the IMF to play an effective role in coordinating efforts of other members, management should provide the Executive Board and member countries with candid assessments of the probability of success of a proposed strategy, including frank feedback when parts of a strategy favored by some members lower this probability. And they should protect the technical judgment of the staff from excessive political interference. Many Directors attached particular importance to

the early involvement of the private sector in crisis resolution. They emphasized that the authorities, not the IMF, should take the lead in negotiations with the private sector.

## Notes

<sup>1</sup> See, e.g., Martin Feldstein, ed., *Economic and Financial Crises in Emerging Market Economies* (Chicago: University of Chicago Press for the National Bureau of Economic Research, 2002); and Stanley Fischer, “The International Financial System: Crises and Reform,” The Robbins Lectures, London School of Economics, October 29–31, 2001.

<sup>2</sup> The IEO was established by the IMF Executive Board in July 2001 in order to systematically conduct objective and independent evaluations “on issues, and on the basis of criteria, of relevance to the mandate of the Fund.”

<sup>3</sup> The evaluation necessarily benefits from hindsight. This can be an advantage in drawing lessons for the future, but much of what is known now may not have been known at the time to those who had to make the relevant decisions, often under extreme pressure. The purpose is to draw lessons, not to establish accountability.

<sup>4</sup> Independent Evaluation Office, *The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil*, Evaluation Report (Washington: IMF, 2003), <http://www.imf.org/external/np/ieo/2003/cac/pdf/all.pdf>.

<sup>5</sup> For additional perspectives on the Indonesian crisis, see J. Soedradjad Djiwandono, “Bank of Indonesia and the Recent Crisis,” 36 *Bulletin of Indonesian Economic Studies* (April 2000), at 47–72; and Jonathan Pincus and Rizal Ramli, “Indonesia: From Showcase to Basket Case,” 22 *Cambridge Journal of Economics* (November 1998), at 723–34.

<sup>6</sup> For additional perspectives on the Korean crisis, see David T. Coe and Sejik Kim, eds., *Korean Crisis and Recovery* (Washington and Seoul: IMF and Korea Institute for International Economic Policy, 2002); and Inseok Shin, ed., *The Korean Crisis: Before and After* (Seoul: Korea Development Institute, 2000).

<sup>7</sup> For additional perspectives on the Brazilian crisis, see Gustavo H.B. Franco, “The Real Plan and the Exchange Rate,” *Essays in International Finance*, No. 217, International Finance Section, Department of Economics, Princeton University (April 2000); and Francisco L. Lopes, “The Brazilian Crisis of 1997–99: An Insider’s View,” paper presented at the conference, “Critical Issues in Financial Reform: Latin American/Caribbean and Canadian Perspectives,” Munk Center for International Studies, University of Toronto, June 2000.

<sup>8</sup> John Crow, Ricardo Arriazu, and Niels Thygesen, “External Evaluation of IMF Surveillance: Report by a Group of Independent Experts” (Washington: IMF, 1999).

<sup>9</sup> For views critical of the high interest rate policy advocated by the IMF in Asia, see Jason Furman and Joseph Stiglitz, “Economic Crises: Evidence and Insights from East Asia,” 1998(2) *Brookings Papers on Economic Activity* 1–135; and Steven Radelet and Jeffrey Sachs, “The East Asian Financial Crises: Diagnosis, Remedies, Prospects,” 1998(1) *Brookings Papers on Economic Activity* 1–90.

<sup>10</sup> For an IMF staff study on this subject, see Carl-Johan Lindgren, Tomas J. T. Baliño, Charles Enoch, Anne-Marie Gulde, Marc Quintyn, and Leslie Teo, *Financial Sector Crisis and Restructuring: Lessons From Asia*, IMF Occasional Paper No. 188 (Washington: IMF, 1999).

<sup>11</sup> For IMF staff studies that have drawn lessons from the crises, see Jack Boorman, Timothy Lane, Marianne Schulze-Ghattas, Aleš Bulíř, Atish R. Ghosh, Javier Hamann, Alex Mourmouras, and Steven Phillips, “Managing Financial Crises: The Experience in East Asia,” 53 *Carnegie-Rochester Conference Series on Public Policy* (December 2000), at 1–67; Atish Ghosh, Timothy Lane, Marianne Schulze-Ghattas, Aleš Bulíř, Atish R. Ghosh, Javier Hamann, Alex Mourmouras, *IMF-Supported Programs in Capital Account Crises*, IMF Occasional Paper No. 210 (Washington: IMF, 2002); and Timothy Lane, Atish Ghosh, Javier Hamann, Steven Phillips, Marianne Schulze-Ghattas, and Tsidi Tsikata, *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment*, IMF Occasional Paper No. 178 (Washington: IMF, 1999).

<sup>12</sup> For a recent effort to incorporate balance-sheet effects into staff analysis, see Mark Allen, Christoph Rosenberg, Christian Keller, Brad Setser, and Nouriel Roubini, “A Balance-Sheet Approach to Financial Crisis,” IMF Working Paper 02/210 (Washington: IMF, 2002).

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## **X. APPENDIXES**

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**I****Main Guidelines on Central Bank  
Autonomy and Accountability****Objectives and Targets**

Price stability, as the best contribution monetary policy can make to balanced sustainable growth, is the preferable formulation for the primary objective. Consistent with this broad objective, a specific target—which could, for example, involve explicit inflation targets, maintenance of a fixed exchange rate, or monetary aggregate targets—should be established and published. These targets may be determined by the central bank (target autonomy), or determined by the government in agreement with the central bank (instrument autonomy). To facilitate accountability, the target(s) should be easy to monitor. Consideration should be given to explicit, but limited, “escape clauses” in the face of significant exogenous shocks.

**Monetary Policy**

A central bank should determine and implement monetary policy to achieve its target. To this end, the central bank should have authority to determine quantities and interest rates on its own transactions without interference from the government.

**Conflict Resolution**

A clear and open process should be established to resolve any policy conflict between the central bank and the government. Some of the aspects below (e.g., the nature of government representation on the board) are potential channels for such a resolution; another approach is to allow the government to direct or overrule the central bank, but such a power should be constrained to avoid other than exceptional use. It should be absolutely clear to the executive, legislature, and the general public that responsibility for the results lies with the government, not the central bank, if the central bank is overruled, its advice ignored, or its effectiveness is significantly limited by government policies. This may require that both the government and the

central bank publish a formal statement to that extent. For instance, in cases where international reserves decline to levels insufficient to conduct international transactions due to factors outside the central bank's control, it shall make recommendations to the government. If the government does not react within a specified period, the central bank should notify the general public that temporarily it cannot be held accountable for price stability due to factors outside its control.

### **Governor**

Nomination and appointment/confirmation of the governor should be by separate bodies to provide some measure of balance, bearing in mind the institutional framework. The term should be longer than the election cycle of the body with the predominant role in selecting the governor. Dismissal should be only for breaches of qualification requirements, or misconduct; lack of performance could also be grounds if clearly defined in terms of the primary objective and specific targets. The latter could be ruled upon according to a suitable and independent judicial procedure, and perhaps be with the consent of the legislature.

### **Board**

Composition of the board should ensure a reasonably well-informed and balanced view, but avoid conflicts of interest. Precisely what is reasonable depends in part on the role of the board (decision-making, monitoring, or purely advisory), and whether it is a single or multiple board structure. The highest-level board should include a majority of nonexecutive, nongovernment directors. Indeed, direct government representatives should be eliminated from a policy board and probably also from a monitoring board. If a government representative does participate in a policy board, it should at least be without the right to vote (though it might be with a limited, temporary veto power). As with the governor, nomination and appointment/confirmation should be by different bodies; terms should be longer than the election cycle of the main body in the appointment process, and should be staggered; and dismissal of board members should occur only for breaches of qualification requirements and misconduct, and on performance grounds only if clearly defined. The latter could be ruled upon according to a suitable and independent judicial procedure, and be with the other board members' prior consent.

## **Credit to Government**

If not prohibited, direct credit to the government should be carefully limited to what is consistent with monetary policy objectives and targets. For example, temporary advances and loans could be allowed only if: (i) they are explicitly limited to a small ratio of average recurrent revenue of preceding fiscal years (say, 5 percent); (ii) they bear a market-related interest rate; and ideally (iii) they are securitized by negotiable securities. The central bank should not underwrite and participate as a buyer in the primary market for government securities, except with noncompetitive bids and within the overall limit for credit to government. Indirect credit to the government, that is, buying outright existing government securities held by the market, or accepting them as collateral, should be guided by monetary policy objectives. The central bank should not finance quasi-fiscal activities.

## **Exchange Rate Policy**

Basic consistency needs to be ensured between the exchange rate and monetary policy. If exchange rate policy (including choice of regime) is not solely the responsibility of the central bank, the bank should nevertheless have sufficient authority to implement monetary policy within the constraint of exchange rate policy (e.g., in a fixed exchange rate regime, to support the exchange rate as the specific target of monetary policy), and should be the principal advisor on exchange rate policy issues (e.g., as to whether the current regime is most suitable for the fundamental price stability objective). In the event of a conflict with the government on exchange rate issues, the conflict resolution procedures as stated above should come into effect.

## **Financial Conditions**

The law should ensure that the central bank has sufficient financial autonomy to support policy autonomy, but with matching financial accountability. Its budget should not be subject to normal annual appropriation procedures (but could be subject to a longer-term appropriation—e.g., on a cycle consistent with the term of the governor). Only realized net profits, after prudent provisioning by the central bank and appropriate allocations to general reserves, should be

returned to the government. The government should ensure the solvency of the central bank by transferring interest-bearing negotiable securities if the authorized capital is depleted. The body to which the central bank is accountable should be allowed to ask external auditors and the auditor general to review the central bank's accounts and procedures.

### **Publication and Reporting**

Policy and financial accountability should be clearly established. The central bank should prepare formal statements on monetary policy performance at, say, six-month intervals, without prior approval by the government. Regardless of to whom the bank is directly accountable, these statements should be forwarded to both the executive and the legislature and should be published for the benefit of the public. Annual financial statements audited by external auditors should similarly be forwarded and published. Summary balance sheets should be published more frequently (e.g., on a weekly or monthly basis).

Sources: Tonny Lybek and JoAnne Morris, "Central Bank Governance: A Survey of Boards and Management," IMF Working Paper 04/226 (Washington: IMF, 2004).

Tonny Lybek, "Central Bank Autonomy, and Inflation and Output Performance in the Baltic States, Russia, and Other Countries of the Former Soviet Union, 1995–97," IMF Working Paper 99/4 (Washington: IMF, 1999), also published in 35(6) *Russian and East European Finance and Trade* 7 (1999).

## The World Bank Operational Manual: Operational Policies— Dealings with De Facto Governments

*These policies were prepared for use by World Bank staff and are not necessarily a complete treatment of the subject. This OP 7.30, dated July 2001, replaces OP 7.30, dated November 1994. Questions may be addressed to the Chief Counsel, Operations Policy.*

1. A “de facto government” comes into, or remains in, power by means not provided for in the country’s constitution, such as a coup d’état, revolution, usurpation, abrogation or suspension of the constitution.

2. A decision to make a loan<sup>1</sup> to, or to have a loan guaranteed by, a country with a de facto government, or to continue disbursing under existing loans to or guaranteed by such country, or to provide a guarantee in respect of a project in the territories of such country,<sup>2</sup> does not in any sense constitute Bank “approval” of the government, nor does refusal indicate “disapproval.” The Bank under its Articles is required to refrain from interfering in the political affairs of any member; moreover, its decisions may not be influenced by the political character of the member country concerned.<sup>3</sup>

3. In many cases, a de facto government either suspends the constitution or abrogates it. In other instances, the constitution and other basic laws remain partially or wholly in force. In either situation, the Bank when continuing disbursements under an existing loan or making a new loan or issuing a guarantee ascertains that (a) a proper legal framework exists to secure approval of the Bank loan or the Bank guarantee and the related counter-guarantee of the country, to permit the project to be carried out, to allow the project objectives to be achieved and to allow the loan to be repaid or any required payments under the country’s counter-guarantee of the Bank guarantee to be made; and (b) all parties to the agreements with the Bank in respect of the project have taken or will be able to take all actions necessary to carry out their respective obligations under their respective agreements with the Bank. The Bank also ascertains that these obligations are or will be valid and binding.<sup>4</sup>

### **Existing Operations**

4. The Bank may not unilaterally suspend disbursements under existing loans<sup>5</sup> or suspend or terminate its obligations under guarantees provided by it unless there are grounds for such suspension or termination based on existing agreements. Thus, the Bank deals with a de facto government with respect to loans made by the Bank before the government assumed power, provided that:

(a) the Bank is satisfied that the government is in effective control of the country (an issue requiring more careful assessment when two or more political or military factions claim to be in control of the national government);

(b) the government generally recognizes the country's past international obligations;

(c) the government states that it is willing and able to assume all of its predecessors' obligations to the Bank;

(d) the government is able to ensure the continued implementation of the relevant project or program; and

(e) the government duly authorizes a representative for the purpose of requesting withdrawals.

### **New Operations**

5. In considering whether to extend a new loan to a country with a de facto government, to make a new loan with the guarantee of such country, or to provide a guarantee in respect of a project in the territories of such country, the Bank first allows a certain time to pass to weigh:

(a) whether a new loan or guarantee would expose the Bank to additional legal or political risks associated with the country's financial obligations and obligations to carry out the project, given the government's de facto nature;<sup>6</sup>

(b) whether the government is in effective control of the country and enjoys a reasonable degree of stability and public acceptance;

(c) whether the government generally recognizes the country's past international obligations, in particular any past obligations to the Bank (in this regard, the Bank examines the country's record; one indicator is whether past governments have generally recognized the obligations incurred by the de facto governments that have preceded them);

(d) the number of countries (particularly neighboring) that have recognized the government or dealt with it as the government of the country; and

(e) the position of other international organizations toward the government.



## Notes

<sup>1</sup> “Loan” includes credits and grants; “Bank” includes International Development Association (IDA); and “project” includes an adjustment program supported under a Bank loan or guarantee.

<sup>2</sup> For information regarding Bank guarantees, see World Bank, “Operational Policies—Guarantees,” OP 14.25, June 2002.

<sup>3</sup> See International Bank for Reconstruction and Development Articles of Agreement, Article IV, Section 10, and IDA Articles of Agreement, Article V, Section 6.

<sup>4</sup> The issues addressed in this OP may arise in the context of a country emerging from conflict. For a general discussion of the Bank’s assistance to countries emerging from conflict, see World Bank, “Operational Policies—Development Assistance and Conflict,” OP 2.30, January 2001.

<sup>5</sup> See World Bank, “Operational Policies—Suspension of Disbursements,” OP 13.40, February 1996.

<sup>6</sup> Agreements between the Bank and its members are governed by international law. International law also prescribes certain principles with respect to de facto governments. Under a general but not unqualified principle of international law, obligations entered into by de facto governments, purporting to be binding on the state, must be honored by successor governments. The qualifications of the general principle may relate to the nature of both the de facto government and the obligation it entered into. For instance, a successor government may question the power of a de facto government that had characterized itself as an interim government to enter into long-term obligations not connected with the immediate needs of the country concerned.

## I. Objectives

The objective of the Sovereign Debt Restructuring Mechanism (SDRM) is to provide a framework that strengthens incentives for a sovereign and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability, thereby reducing the cost of the restructuring process. In order for the SDRM to achieve these objectives, it must be a part of a general effort to strengthen the framework for crisis prevention and resolution, including the policies on lending into arrears and on exceptional access to IMF resources.

## II. Principles

The design of the SDRM would be guided by the following principles:

- The mechanism should only be used to restructure debt that is judged to be unsustainable by the debtor. It should neither increase the likelihood of restructuring nor encourage defaults.
- In circumstances where a member's debt is unsustainable, the mechanism should be designed to catalyze a rapid restructuring, both in terms of when it is initiated and, once initiated, when it is completed.
- Any interference with contractual relations should be limited to those measures that are needed to resolve the most important collective action problems.
- The framework should be designed in a manner that promotes greater transparency in the restructuring process.
- The mechanism should encourage early and active creditor participation during the restructuring process.

- The mechanism should not interfere with the sovereignty of debtors.
- The framework should establish incentives for negotiation—not a detailed blue print for restructuring.
- The framework needs to be sufficiently flexible—and simple—to accommodate the operation and evolution of capital markets.
- Since the framework is intended to fill a gap within the existing financial architecture, it should not displace existing statutory frameworks.
- The integrity of the decision making process under the mechanism should be safeguarded by an efficient and impartial dispute resolution process.
- The formal role of the IMF under the SDRM should be limited.

### **III. Scope of Claims**

(a) While the mechanism would identify the scope of claims that could potentially be subject to a restructuring (“eligible claims”), whether all or some of these claims would be restructured in a particular case would be determined by the debtor, in light of negotiations with its creditors.

(b) For purposes of the mechanism, and subject to (c) below, eligible claims would be limited to rights to receive payments from the specified debtor (as defined in the mechanism): (i) that arise from a contract relating to commercial activities of the specified debtor and (ii) that are neither governed by the laws of the member activating the SDRM, nor subject to the exclusive jurisdiction of a tribunal located within the territory of that member. Eligible claims would also include claims for payment of judgments resulting from a right to receive payments under a contract that meets criterion (i) above, if the enforcement of such judgment is sought outside of the territory of the member activating the SDRM.

(c) For purposes of the mechanism, a specified debtor would comprise the central government of the member activating the mechanism and, subject to consent of the debtor in question, could also include (i) the central bank or similar monetary authority of the

member and (ii) any local governments or public entities within the territory of the activating member that are not subject to a domestic statutory debt restructuring framework.

- (d) Notwithstanding the above, eligible claims would exclude:
  - (i) Claims that benefit from a statutory, judicial or contractual privilege, to the extent of the value of such a privilege unless such a privilege (A) was created after activation and (B) arises from legal enforcement proceedings against a specified debtor;
  - (ii) Guarantees or sureties, unless the underlying claim benefiting from such a guarantee or surety is in default;
  - (iii) Wages, salaries and pensions;
  - (iv) Contingent claims that are not due and payable, unless such contingent claim possesses a market value;
  - (v) Claims held by international organizations that are specified in the amendment.<sup>1</sup> (The amendment would authorize the Board of Governors, by an eighty-five percent majority of the total voting power, to amend the initial list of such organizations and claims); and
  - [(vi) Claims held by foreign governments or qualified governmental agencies.]<sup>2</sup>

#### **IV. Activation**

Consistent with the principle of sovereignty, the mechanism could only be activated at the initiative of the member whose debt is to be restructured. When activating the mechanism, the member would represent that the debt to be restructured was unsustainable. For purposes of the legal effectiveness of activation, this representation would not be subject to challenge.

#### **V. Provision of Information**

Upon activation, a procedure would unfold that would require the activating member to provide all information regarding its indebtedness and the indebtedness of all specified debtors (including debt that will not be restructured under the SDRM) to the Dispute Resolution

Forum (DRF). The activating member would be expected to present the following information:

- (i) a list of claims for which restructuring is sought under the SDRM (“SDRM Restructuring List”);
- (ii) a list of claims for which restructuring is sought outside of the SDRM (“Non-SDRM Restructuring List”); and
- (iii) a list of claims for which no restructuring is sought.

Such information shall be published by the DRF. Upon notification to the DRF, a debtor may also modify these lists during the restructuring process.

## **VI. Registration and Verification of Claims**

Once the activating member provides the above-mentioned information, a registration and verification process would take place that would enable creditors to be in a position to vote on an aggregated basis for each specified debtor. Only those creditors whose claims are included on a SDRM Restructuring List and who wish to participate in the voting would have to register. Creditors whose claims are on a SDRM Restructuring List, but who fail to register within the specified period would not be entitled to vote, but their claims would be restructured on the terms approved by the required majority of holders of verified claims (“verified claims”). Claims would be considered verified unless challenged. The DRF would have the responsibility for adopting rules regarding the registration and verification process, with the objective of safeguarding the overall integrity and transparency of the process on the one hand, and preserving asset values through a timely process, on the other hand.

## **VII. Limits on Creditor Enforcement**

(a) When, after the date of activation but prior to the certification of a restructuring agreement, a holder of a claim that appears on a SDRM restructuring list has recovered amounts due on the claim through legal proceedings (enforcing creditor), the claim of the enforcing creditor shall be restructured as follows: (i) first, the percentage of reduction offered to all other claims in the same class will be calculated with respect to the claim of the enforcing creditors on the

basis of the value of the claim at the time of activation (the notional restructured amount); and (ii) second, the amount recovered through post-activation legal proceedings shall be deducted from the notional restructured amount.

(b) Upon the request of an activating member and the approval by creditors holding 75 percent of the outstanding principal of verified claims on a specified debtor, a temporary suspension (stay) would become effective for all enforcement proceedings brought by creditors holding claims on a SDRM Restructuring List involving that specified debtor or its assets. The period of the suspension would be as requested by the activating member and approved by the creditors.

(c) Upon the request of an activating member and, upon the approval of holders of verified claims on a specified debtor, the DRF will issue an order to suspend particular enforcement proceedings against a specified debtor or its assets brought by creditors holding claims on a SDRM restructuring list if, in the assessment of the DRF, the proceeding has the potential to undermine a SDRM restructuring; prior to the completion of the registration and verification process, creditor approval will be evidenced by approval of a representative creditors' committee; thereafter, the issuance of any new order or the continued effectiveness of an existing order will require the approval of creditors holding 75 percent of outstanding principal of verified claims.

*[Although the approach set forth in Section 7 is supported by many Executive Directors, a number of Executive Directors are of the view that a general cessation of payments and a temporary automatic stay should be a feature of the mechanism.]*

## VIII. Creditor Committees

As a means of encouraging active and early creditor participation in the restructuring process, a representative creditors' committee, if formed, would be given a role under the SDRM to address both debtor-creditor and inter-creditor issues. Consistent with best practices in this area, the debtor would bear the reasonable costs associated with the operation of these committees. The DRF would have the authority to review these costs and limit the amount recoverable from the debtor where they appear to be excessive.

*[Although the approach set forth in Section 8 is supported by many Directors, some Directors expressed the view that costs of creditors' committees should be borne equally between the debtor and its creditors.]*

## **IX. General Voting Rules**

Subject to Section 11 below,<sup>3</sup> creditor approval of proposals made by a specified debtor regarding: (i) a stay on enforcement, (ii) priority financing, and (iii) the terms of a restructuring agreement would be made by creditors holding 75 percent of the outstanding principal of verified claims. Holders of verified claims who are under the control of a debtor shall not be entitled to vote.

## **X. Priority Financing**

As a means of inducing new financing, the SDRM would provide that a specified post-activation financing transaction could be excluded from the restructuring if the extension of such financing is approved by creditors of 75 percent of outstanding principal of verified claims. Where such a decision has been taken, the DRF would be precluded from certifying an agreement that restructured such excluded financing absent the consent of the creditor that had extended the financing in question.

## **XI. Restructuring Agreement**

(a) When a specified debtor proposes a restructuring agreement, it would also be required to provide information to the DRF as to how it has treated or how it intends to treat claims that are not to be restructured under the SDRM, thereby enabling holders of verified claims to make a decision regarding the sovereign's proposal with the full knowledge of the treatment of other claims.

(b) Holders of verified claims would be requested to vote on a proposed restructuring agreement, except for holders of unimpaired claims. For purposes of the mechanism, a creditor would be considered unimpaired if the restructuring of the creditor's claim was limited to a reversal of any acceleration of the claims in question, provides for the immediate payment of all outstanding interest, and no other default is continuing. Any such unimpaired claim will be

deemed to be reinstated despite activation of the SDRM. A separate restructuring agreement would be proposed for each specified debtor. Once certified by the DRF, an agreement would become binding with respect to all registered claims and all claims that appeared on an SDRM Restructuring List but were not registered. Subject to the classification rules below, all holders of eligible claims would have to be offered the same restructuring terms or the same menu of terms.

(c) If official bilateral claims are included under the SDRM, they would be subject to mandatory classification.

(d) As a means of facilitating a restructuring agreement amongst creditors with different preferences, a debtor would have the option—but not the obligation—of creating different classes of registered claims. In such cases, holders of claims in different classes could be offered different terms. The approval of 75 percent of outstanding principal of verified claims in each class would be a condition for the effectiveness of the overall agreement. Classification could not be used in a manner that would result in the discriminatory treatment of similarly situated creditors.

## **XII. Termination**

The SDRM procedure would terminate:

- (i) automatically upon the certification of all restructuring agreements by the DRF;
- (ii) by notice of termination given by the central government of the member that had activated the mechanism; or
- (iii) by an affirmative vote of creditors holding 40 percent of the outstanding principal of verified claims (after completion of the registration and verification process).

## **XIII. Dispute Resolution Forum**

(a) The DRF would be established and organized in a manner that ensures independence, competence, diversity and impartiality. The DRF, whose operations would be financed by the IMF, would be established and organized as follows:



(i) First, upon the advice of international organizations (such as UNCITRAL) and professional associations with expertise in insolvency and debt restructuring matters, the Managing Director would designate a selection panel of 7–11 highly qualified judges or private practitioners.

(ii) Second, the selection panel would be charged with identifying 12–16 candidates that would constitute the pool from which the DRF panel would be selected when a crisis arises. Although the amendment would specify the qualification criteria (e.g., judicial experience in debt restructuring matters), the nomination process would be an open one. Once selected, this pool would be approved by the Board of Governors by an “up or down” vote. Except for the President of the DRF, all members of the pool would continue to work in their other capacities until impaneled.

(iii) Third, when the SDRM is activated, four members of the pool would be impaneled by the President of the DRF. One of these members would be responsible for making initial determinations. The remaining three members would constitute an appeals panel.

(b) The responsibilities of the DRF would be limited. It would have no authority to challenge decisions of the Executive Board or make determinations on issues relating to the sustainability of a member’s debt. Its primary functions are summarized as follows:

(i) Administrative Functions—this would include notification to creditors, registration of claims and the administration of the verification and voting process. It would also include the certification of decisions taken by the requisite majority of creditors.

(ii) Dispute Resolution—the DRF would be charged with resolving disputes that will arise during the SDRM restructuring process and would have exclusive jurisdiction over such disputes during this period. In performing this function, the DRF will be reactive: it will not initiate investigations regarding potential issues, but will merely adjudicate disputes brought by a party. While it could request the parties to provide evidence, the DRF would have no subpoena power.

(iii) Suspending enforcement—upon the request of the debtor and upon the approval by creditors or their representatives, the DRF may issue an order that will enjoin specific enforcement actions during the restructuring process when it determines that such enforcement actions could seriously undermine the restructuring process.

(c) In order to discharge the above responsibilities, the DRF would have the power to issue rules and regulations, which would enter into force unless overruled by the Board of Governors, by an eighty-five percent majority of the total voting power, within a specified period.

#### **XIV. Legal Basis of the SDRM and Its Consistency with Domestic Laws**

The SDRM and the DRF could be established through an amendment of the IMF's Articles, which requires acceptance by three-fifths of the members, having eighty-five percent of the total voting power. Since the amendment will involve the establishment of new treaty obligations that will affect the rights of private parties under domestic legal systems, most countries will need to adopt legislation for acceptance of an amendment or for making the new provisions effective under their internal law. It is for each member to determine the extent to which the adoption of the SDRM would require changes in its domestic laws.

### Notes

This Appendix has been reprinted from IMF, “Proposed Features of a Sovereign Debt Restructuring Mechanism” (February 12, 2003), <http://www.imf.org/external/np/omd/2003/040803> (alterations and footnotes in original).

<sup>1</sup> If this approach is followed, the modalities for restructuring the eligible claims of international organizations that are not on the exclusion list would also need to be addressed.

<sup>2</sup> Pending outcome on discussions regarding the treatment of official bilateral claims under the SDRM.

<sup>3</sup> If official bilateral claims are included under the SDRM, they would also vote as a separate class for purposes of a stay on enforcement and priority financing.

## **BIOGRAPHICAL SKETCHES**

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## Biographical Sketches

**Fabian Amtenbrink** is an Associate Professor for European Law at the University of Groningen. In addition, he was appointed as fellow at the Center for the Study of Law, Administration, and Society (CRBS). A graduate of the Freie Universität Berlin, he obtained a doctorate in law from the University of Groningen in the Netherlands, and he is a fully qualified lawyer in Germany. A commercial edition of his comparative study on the democratic accountability of the European Central Bank has been published by Hart Publishing, Oxford. He publishes frequently on issues relating to central bank governance and economic and monetary union, as well as on other aspects of European law, including a major textbook on European Union law.

**Patrick Bolton** is the Barbara and David Zalaznick Professor of Business at Columbia Business School and Professor of Economics at Columbia University. He specializes in the general area of contract theory and contracting issues in corporate finance and industrial organization. A central focus of his research is on the allocation of control and decision rights to contracting parties when long-term contracts are incomplete. His work in industrial organization focuses on antitrust economics and the potential anticompetitive effects of vertical contracting practices. He is a former managing editor for *The Review of Economic Studies*, and current editor of *The Journal of the European Economic Association*. He is a fellow of the Econometric Society, the National Bureau of Economic Research, the Center for Economic Policy Research, and the European Corporate Governance Institute. Mr. Bolton received his Ph.D. from the London School of Economics in 1986 and holds a B.A. in economics from the University of Cambridge and a B.A. in political science from the Institut d'Etudes Politiques de Paris. He is the coauthor with Mathias Dewatripont of *Contract Theory* (MIT Press, 2005) and he has co-edited with Howard Rosenthal *Credit Markets for the Poor* (Russell Sage Foundation, 2005).

**Jeff Breinholt** received his B.A. from Yale University in 1985 and J.D. from University of California, Los Angeles in 1988. He is a member of the State Bar of California, and currently serves as the Deputy Chief, Counterterrorism Section United States Department of Justice (DOJ), where he heads a team of financial prosecutors

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**Robert Peck Christen** is the President of the Boulder Institute of Microfinance, whose widely-recognized Microfinance Training Program has trained over 2,000 industry leaders from 130 countries in the latest models and techniques for providing financial services to the world's poor. Mr. Christen has worked in microfinance for 25 years in over 40 countries, most recently for 6 years as Senior Advisor to the Consultative Group to Assist the Poor, where he led work on agricultural microfinance, regulation, and supervision, creating transparency in the marketplace and developing microfinance in commercial banks. Mr. Christen founded the *MicroBanking Bulletin*, the industry financial benchmarking publication, and continues to chair its editorial board. He was a founder of the Microfinance Information eXchange (MIX) and the Microfinance Management Institute (MMI).

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