The Regulation and Supervision of International Lending: Part I

Introduction

Beginning with a brief overview of the importance of bank regulation and supervision for prudent international lending by commercial banks and long-term resolution of the LDC debt crisis, this analysis proceeds to a comparison of selected bank regulatory and supervisory practices in several major creditor countries. It then turns to questions of appropriate reforms in domestic bank regulation and improved regulatory coordination among the major creditor countries as well as a greater role for international supervisory agencies.

I. The Regulation and Supervision of International Lending

A. The Economic and Regulatory Dimensions of the LDC Debt Crisis

Over thirty developing countries (LDCs) completed or were engaged in

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1. There is a traditional distinction between “regulation” and “supervision.” Regulation consists of authoritative rules or principles dealing with details of procedure. WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE, 1913 (1968, unabridged). One thoughtful definition states that “regulation is the public administrative policing of a private activity with respect to a rule prescribed in the public interest.” B. MITNICK, THE POLITICAL ECONOMY OF REGULATION 7 (1980). Supervision is a more general oversight, critical evaluation or direction with authority. WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY, supra, at 2296. The authors of a recent government report stated that, “Regulations implement laws that govern the types of services organizations can provide. Supervision . . . involves the direct assessment of operations to determine how adequate or safe they are.” J. HOUPT & M. MARTINSON, FOREIGN SUBSIDIARIES OF U.S. BANKING ORGANIZATIONS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, STAFF STUDY NO. 120 (Oct. 1982), at 14.

2. The terms “LDC debt crisis” and “global debt crisis” are often used interchangeably. Because this analysis deals with bank regulation and supervision primarily in the context of developing countries, the term “LDC debt crisis” is used throughout.
debt reschedulings during 1984.\(^3\) The total debt of these economically troubled countries was approximately $400 billion at the end of 1984, or more than half of the total estimated LDC debt of close to $700 billion.\(^4\) An additional $100 billion of LDC debt is expected to come due between 1985 and 1987.

Precise numerical figures about the extent of the LDC debt crisis are difficult to obtain. However, figures of the International Bank for Reconstruction and Development (the World Bank) indicate that between 1970 and 1984 the outstanding medium and long-term debt of developing countries expanded almost tenfold, to $686 billion. In the World Bank’s view, “[t]he most striking feature of this growth was the surge in lending by commercial banks. Their share of total new flows to developing countries increased from 15 percent in 1970 to 36 percent in 1983.” The World Bank concluded that “on every measure, the debt-servicing abilities of the developing countries deteriorated . . . as their debt increased.”\(^5\) The World Bank’s figures indicate that:

The ratio of debt to GNP more than doubled, from 14 percent in 1970 to almost 34 percent in 1984. The ratio of debt service to exports rose from 14.7 percent in 1970 to a peak of 20.5 percent in 1982, declining to 19.7 percent in 1984. Interest payments on debt increased from 0.5 percent of GNP in 1970 to 2.8 percent of GNP in 1984 and accounted for more than half of all debt service payments in that year.\(^6\)

Such facts prompted former Secretary of State Henry Kissinger to remark that, “[d]ebt payments of such magnitude] simply cannot be made. None of the major debtor countries will be able simultaneously to pay its debts, achieve economic growth and maintain its political and social equilibrium,”\(^7\)

The origins of the LDC debt crisis are often attributed to problems of recycling oil-related funds following the oil shocks of the 1970s. Former Secretary of the Treasury Donald Regan has commented that, “the present troubled state of the world economy has its roots in the emerging inflationary pressures of the late 1960s, the twin oil shocks of the 1970s and policy responses that attempted to avoid adjustment to new economic realities.”\(^8\)

\(^3\) **World Bank, World Development Report**, at 4 (Figure 1.3) (1985).

\(^4\) **World Bank, Net Capital Flows and Debt, 1975–84**, id. at 2, (Figure 1.1).

\(^5\) Id.

\(^6\) Id. These averages conceal wide regional and country differences. For example, in Argentina in 1982, debt service as a percentage of exports was 102.9 percent. W. R. Cline, **International Debt: Systemic Risk and Policy Response**, at Statistical App., Table E-2 (1984).

\(^7\) Kissinger, *West Must Move to Ease Debt Crisis in Latin America*, L.A. Times, June 24, 1984, at 1 (available on NEXIS).

\(^8\) Secretary of the Treasury Donald Regan, testimony before the House Committee on Banking, Finance and Urban Affairs, H.R. Rep. No. 175, 98th Cong., 1st Sess. 30 (1982) (testimony of Sec. of Treas. Donald Regan), Report accompanying H.R. 2957, 98th Cong., 1st Sess., (1983) [hereinafter cited as Rep 98–175]. For an early statement of this argument, see
The economic causes of the current LDC debt crisis have also been assessed in depth by the IMF, the Bank for International Settlements (the BIS) and the World Bank. The World Bank has observed that "the much publicized debt difficulties of the past two years came to a head because of the unusual combination in 1980-1983 of recession and high real interest rates in the industrial countries." Moreover, in the World Bank's view, developing countries have become more vulnerable to debt-servicing difficulties in the 1980s for three related reasons. First, loans have far outstripped equity finance. Second, the proportion of floating interest rate debt has risen dramatically. Third, loan maturities have shortened considerably, to a large extent because of the declining share of official capital flows and debt. The IMF has emphasized that the recent difficult phase in the debt crisis could be traced to declining output in industrial countries and the corresponding interruption in world trade patterns. The BIS has viewed the debt problem as one consequence of the transition from inflation to disinflation in the world economy.

As central as they are to an understanding of the debt crisis, economic factors should not be considered in isolation. While the principal cause of the debt crisis is surely to be found in the economic factors referred to above, there remains the question of whether bank regulators and supervisors should have had greater foresight in anticipating these unprecedented economic developments. One observer has spoken of the "regulatory free-for-all [that] has contributed to the very grave crisis now engulfing the international banking system." Another has argued that, "[m]any of the critical risks now faced by the international financial system are directly attributable to . . . failures of the present scheme of bank regulation." A third has declared that, "[w]e are faced with the worldwide over-commitment of an interlocking banking system and potential default on a scale that could exceed the entire capital and reserves of the world's most famous banks."


The time has come to supplement analysis of the economic causes of the LDC debt crisis with a focus on its bank regulatory and supervisory aspects. W. P. Cooke, head of banking supervision at the Bank of England, has questioned whether the current crisis "may not point increasingly toward a need for a single global regulatory framework within which banks should conduct their international business." Built on shared expectations rather than extensive formal structures, Cooke's "framework" would be supported by domestic bank supervisors and regulators working to reconcile the nuances and facilitate the achievement of these common objectives. Cooke has suggested that such a framework "should be capable of withstanding shocks, with an in-built resilience, but at the same time containing rules, yardsticks, guidelines . . . for example, in the areas of capital adequacy, liquidity and concentrations of risk."

The ad hoc nature of current regulatory and supervisory procedures and the lack of full agreement on objectives among bank regulatory and supervisory agencies represent one regulatory aspect of the problem. However, even when governments have developed programs for regulatory guidance of international lending and banking practices, such programs have often had the unintended consequence of encouraging misdirected lending patterns. At least one observer has spoken of "how the increase in government involvement itself contributed to the banking crisis." Government loan guarantees provided by agencies such as the Export-Import Bank in the United States and government involvement through agencies such as the IMF and the World Bank have encouraged lending patterns to develop in particular ways that sometimes seem wrong in retrospect. At times, large industrial complexes have been favored at the expense of the development of agriculture. In addition, short-term lending to developing countries has at times been encouraged by bank examiners because it contributes to the flexibility of a commercial bank's liquidity position. But short-term lending also increases the vulnerability of the banking system as a whole to sudden contractions of capital.

The meetings of central bankers held in New York in early May 1984 at the invitation of the Federal Reserve Bank of New York highlighted the role of bank regulators and supervisors in resolving the LDC debt crisis. The discussions revealed a growing belief that the often ad hoc strategy which bank supervisory agencies and commercial banks in the leading creditor

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17. *Id.* at 2.
countries had utilized since 1982 could not be relied upon to work in view of volatile interest rates which could increase the cost of variable rate loans, a growing reluctance among borrowers such as Argentina and Brazil to accept economic austerity programs imposed by the IMF as the price of new lending, and a general crisis of confidence in the international banking system.20

Perhaps for the first time, there is a consensus among bank regulators and supervisors and commercial banks in creditor countries that basic reforms in domestic and international supervision and regulation of the international lending practices of commercial banks are needed.21 There is a recognition that “a banking system that is constantly on the brink of disaster and subject to never-ending threats of default does not inspire confidence.”22

Moreover, as part of a continuing effort dating back to the establishment of the Cooke Committee in 1975, domestic bank supervisors have increasingly worked towards consolidated supervision of commercial bank lending practices. In doing so, they have given greater attention to problems arising from offshore banking centers and the interbank market. Offshore banking centers generally provide only minimal constraints on bank subsidiaries and branches within their jurisdiction.23 The international interbank market, in which banks lend to one another, now has an estimated worth of $1,000 billion and has been described as the “powerhouse of international lending.”24 Yet, “paradoxically for a market which is so central to the operation of the international banking system, it has thrived and prospered on an unregulated basis.”25

The new focus on reform in the regulation and supervision of commercial banks' international activities is understandable and overdue, since international lending developed rapidly during the 1960s and 1970s with little

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22. Rep. 98–175, supra note 8, at 22.


corresponding growth in domestic or international bank regulation and supervision. As one report noted, "[t]he rise in multinational banking and the increased importance of liability management in international finance had also greatly increased the integration of the world’s financial system, but national regulators had as yet devoted little attention to increased international regulatory cooperation."\(^{26}\)

In part, the new emphasis on regulation and supervision is a reflection of a growing disenchantment with the unevenness of rules and restraints imposed by bank supervisors in major creditor countries and a recognition that new patterns of regulation and supervision creating shared expectations and facilitating systematic stability will be needed.\(^{27}\)

**B. The Objectives of Regulatory Reform**

Domestic bank supervisory policies that will promote disclosure of international lending practices and exposures, enhance the safety and soundness of the international banking system, encourage competition among major commercial banks and facilitate global economic growth are desirable.\(^{28}\)

While disclosure, confidence and competition are all important independent objectives of regulatory reform, the relationship among them must also be considered. Moreover, while the bank supervisory process must be strengthened, it must also be made more flexible.\(^{29}\)

Disclosure of pertinent information about international lending should be tempered by a recognition that too much disclosure may sometimes conflict with prudential concerns. As E. Gerald Corrigan, President of the Federal Reserve Bank of New York, has stated: "We cannot allow the legitimate demand for disclosure and market discipline to overwhelm the integrity of the process whereby banks and their supervisors can freely go about the business of solving problems."\(^{30}\) Competition among commercial banks, both domestically and internationally, must be linked with a recognition that the integrity of the international banking system and public confidence


\(^{27}\) See, e.g., Cline, supra note 11, at 98. Cline observes that "the basic problem regulatory reform needs to address is the overextension of sovereign lending beyond limits that are prudent for the system."

\(^{28}\) Historically, the broad goals of U.S. banking regulation and supervision have reflected some of these objectives. These goals have included insuring the stability of the banking system, protecting individual depositors and fostering competition among banks. HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 96TH CONG., 1ST SESS., THE OPERATIONS OF U.S. BANKS IN THE INTERNATIONAL CAPITAL MARKETS, 25 (1979).

\(^{29}\) Remarks of E. Gerald Corrigan, 57th Annual Mid-Winter Meeting of the New York State Bankers Association (Jan. 31, 1985), reprinted in FEDERAL RESERVE BANK OF NEW YORK QUARTERLY REVIEW 4 (Spring 1985) [hereinafter FRBNY Q. REV.]

\(^{30}\) Id.
in it may at a particular time supersede competitive goals. Finally, the potentially heavy hand of regulators should not be allowed to interfere in a fundamental way with the flows of capital that provide the impetus for global economic growth.

More uniform guidelines for domestic bank regulation and supervision of international lending practices would be helpful aids to coordination and cooperation among domestic bank regulatory systems. They would provide a constructive background for greater international cooperation. A report of the House Committee on Banking, Finance and Urban Affairs was unequivocal on this point: "If the [domestic] bank regulatory agencies around the world are not able to cooperate and coordinate their actions, it is difficult to imagine how the present debt problem can be solved or similar problems prevented from arising again in the future."31

C. COMMON THEMES IN THE DOMESTIC SUPERVISION OF INTERNATIONAL LENDING

While current regulatory systems vary considerably, it is possible to isolate some common themes among the major creditor countries. Thus, domestic approaches to the LDC debt crisis will be analyzed in terms of the following basic areas: (1) The relationship between government and central bank controls; (2) accounting and disclosure rules; (3) general rules for the prudent conduct of a banking business, including limits on loans to single borrowers, capital adequacy and liquidity ratios, and foreign exchange restrictions; (4) specific rules for international lending, including country risk analysis and provisions for loan losses, lender of last resort functions, control over foreign branches and subsidiaries of domestic banks and controls on foreign banks operating domestically; and (5) attitudes towards international cooperation.

D. INTERNATIONAL SUPERVISION OF LENDING PRACTICES

Beyond the development of more uniform domestic regulatory goals and greater cooperation among domestic regulatory agencies, there remains the question of what role, if any, should be played in the regulatory process by international agencies such as the IMF and the World Bank. Should these agencies, which have thus far been assigned functions which are primarily related to capital flows between developed and developing countries be given a supervisory role as well? Should the BIS be given supervisory functions in addition to its primary role as banker for central banks?

At present, the guiding document for international supervision of lending

31. REP. 98-175, supra note 8, at 42.
practices is the Basle Concordat. As written in 1975, the Basle Concordat assigned supervisory authority for subsidiaries of foreign banks to central banks of host countries. In 1983, the Basle Concordat was updated to clarify that both host country and parent country central banks jointly shared responsibility for supervision of branches and subsidiaries with respect to liquidity. As to solvency matters, branches were to be supervised by parent country central banks while joint parent-host country supervision was to apply to subsidiaries.

In one respect, the Basle Concordat, which does not look beyond the host-parent dichotomy for a possible international regulatory or supervisory solution, is evidence of a tension between domestic and international supervisory levels that cannot be overcome. In the absence of authoritative enforcement mechanisms, the international level must remain one of cooperation and coordination. Yet the question remains whether that cooperative and coordinating role can best be developed by the joint efforts of domestic bank supervisory and regulatory authorities or whether there is a viable but as yet undeveloped regulatory role that might usefully be assumed by the BIS, the World Bank and the IMF.

E. A CAVEAT: BANK REGULATION AND WORLD ECONOMIC RECOVERY

While enlightened bank regulation and supervision can help achieve the objectives of stability and growth in the international financial markets, even carefully designed regulatory systems cannot insure that there will be no future threats to the liquidity or solvency of commercial banks from international lending. The simple fact is that “bank regulation cannot avert or solve worldwide economic problems...” Furthermore, bank regulation is not intended to replace bank management.”


33. Some observers have been highly critical of the so-called “Cooke Committee,” an informal adjunct of the BIS which produced the Basle Concordat: “The [Cooke] Committee meets in secret and its deliberations are confidential. Moreover, what little is known of the [Cooke] Committee’s decisions suggests something quite different from a unified international perspective.” Rep. 98–175, supra note 8, at 43.

Nor can changes in bank supervisory practices affect borrowers' needs for funds. Worldwide economic growth and recovery would clearly help to alleviate the LDC debt crisis by reducing the need for borrowing and much attention has been focused on ways to achieve that goal. The 1983 annual report of the World Bank concluded, for example, that:

What is needed for sustained world economic growth is concerted action by both the industrial and the developing countries. The former to help provide a more stable and favorable external economic environment through steady but noninflationary expansion, a more open trading system, and continued steady growth in both commercial and concessionary capital flows. The latter, by adopting policies that increase efficiency.

However, while a continued decline in United States interest rates, coupled with strong economic growth in the debtor countries, higher commodities prices and a general expansion of trade between debtor and creditor countries would ease the LDC debt crisis, growth without accompanying development of new patterns of supervision and regulation of international lending would provide only a temporary and illusory "solution."

Another problem with economic solutions is that they do not adequately address the short-term aspects of the international lending crisis. In the short run, governments must play a role in maintaining capital flows to debtor countries, reducing the burden of interest payments and stemming the rise of protectionism. At present, the most meaningful key to a solution to the debt crisis is the restoration of confidence and stability to the international banking system. A focus on increased trade and economic growth will not directly affect the size, repayment terms or continuation of loans from creditor to debtor countries. Governments must create systems of banking supervision and regulation that promote the safety and soundness of banks while facilitating continued flows of credit from creditor to debtor countries.

36. There has been an interesting debate among economists as to whether a reduction in interest rates or a surge in general economic growth in the industrialized world would more quickly ease the debt burden.
37. WORLD BANK, WORLD DEVELOPMENT REPORT 26 (1983). A similar emphasis can be found in IMF, supra note 11, at 1-2. The IMF report also expressed concern about the "efficiency" of efforts to promote economic growth in developing countries. Id. at 42.
38. BIS, supra note 12, at 181: "From every conceivable angle, the most important and most urgent task for policy is to exert downward pressure on U.S. interest rates."
39. It is interesting to note that even among West European commercial bankers who have long tended to view high U.S. interest rates as a major cause of the debt crisis, there is growing sentiment in favor of closer cooperation among domestic supervisors and enhanced roles for international supervisory agencies.
II. Bank Regulation and Supervision in the United States

A. Generally

The United States approach to supervision of international lending by commercial banks has been marked by frequent confrontation between the Treasury Department and the Federal Reserve Board (the FRB) over the appropriate level of funding for international agencies such as the IMF and the World Bank as well as the adequacy of current rules governing international lending practices of commercial banks. The Comptroller of the Currency (the Comptroller) and the Federal Deposit Insurance Corporation (the FDIC) have also made numerous statements on various aspects of the LDC debt crisis. Even within the FRB, there has apparently been a debate over the efficacy of current structures for dealing with debt rescheduling and other matters relating to the LDC debt crisis. FRB Chairman Volcker has stated his opposition to global supervisory solutions or negotiations between creditor and debtor countries because "we already have a process that seems to work." Vice Chairman Preston Martin, on the other hand, has been a proponent of a more activist approach to bank supervision and the debt crisis.41

An adversarial tone has entered into relations between commercial banks and their primary federal regulators on matters relating to disclosure of foreign loans and development of more stringent capital adequacy requirements. Commercial banks have appeared reluctant to discuss problems of interpretation and application of rules with their regulators and are clearly eager to make new rules on international lending apply to them as modestly and narrowly as possible.42 There is, at present, no uniform set of guidelines or regulations that applies consistently to commercial banks engaged in lending to developing countries.43

1. The Dual Banking System

Historically, banks in the United States have been able to choose between

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42. A number of commentators have referred to the "formal and legalistic character" of banking regulation and supervision in the United States. See, e.g., A. Spindler, The Politics of International Credit: Private Finance and Foreign Policy in Germany and Japan 191 (1984) [hereinafter cited as Spindler]. It is commonly acknowledged that a complex regulatory structure has helped to insulate the banking system from "executive interference and discretion." Id. But a corollary has been the development of equally elaborate means of circumventing rules and regulations not desired by commercial banks. See J. Zysman, Governments, Markets and Growth 266-281 (1983). Zysman's description of the complexities of a capital market-oriented and price-competitive financial system provides a useful background for understanding the U.S. banking regulatory structure.
43. For a discussion of the "weakly coordinated and disparate elements" comprising the federal bank regulatory structure, see M. Cohen, supra note 14, at 212.
federal charters and state charters. National banks with federal charters are regulated by the Comptroller, are automatically member banks of the Federal Reserve System and are covered by insurance through the FDIC. State-chartered banks may be insured member banks of the Federal Reserve System, in which case they are regulated by the FRB, or nonmember insured banks, subjecting them to regulation by the FDIC. Only a handful of state-chartered nonmember noninsured banks are in existence, and they are not significant international lenders.  

The existence of state-chartered and federally-chartered banks with separate primary federal regulatory agencies has meant the development of distinctive and sometimes contradictory supervisory patterns which have extended to regulations affecting international lending. Historically, the Comptroller has developed the most comprehensive system of regulation of international lending. For example, the Comptroller began examining the overseas units of national banks in 1965. In 1973, the Comptroller began requiring all national banks to file reports of condition on a global consolidated basis. International Debt, Hearings Before the Subcomm. on International Finance and Monetary Policy of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 1st Sess. 351 (1983) [hereinafter cited as REP. 98–81] (statement of C. Todd Conover, former Comptroller of the Currency).

2. The FRB and the Treasury Department

The Treasury Department and the FRB have some shared responsibilities in the area of general monetary and fiscal policy. Because of the Comptroller's relation to the Treasury Department, there is frequent opportunity for rivalry and disagreement between the FRB and the Comptroller over regulatory policies relating to commercial banks. The Treasury Department and the FRB have also taken somewhat different approaches to the general handling of the LDC debt crisis. In separate statements early in May of 1984, Martin Feldstein, the former chairman of President Reagan's Council of Economic Advisers, and Paul Volcker, Chairman of the FRB, emphasized

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46. REP. 98–16, statement of William Isaac, at 217. See also REP. 98–81 at 382: "Bank regulators were insufficiently sensitive to the developing problems in foreign lending and failed to take firm steps to limit credit concentrations and the leveraging of bank capital."
that rising U.S. interest rates posed a grave threat to rescheduling efforts and rendered the crisis management approach of the past quite ineffective. Former Secretary of the Treasury Donald Regan, on the other hand, served as the spokesman for the Reagan Administration policy of IMF conditionality, developing country "adjustment" and austerity, modest resources for the World Bank, and opposition to more government regulation of commercial banks.47

3. Commercial Banks and the Supervisory Process

Commercial banks have had yet another perspective on IMF funding and the general supervision of banks by the three federal bank regulatory agencies. In congressional hearings on proposed IMF funding increases, for example, commercial bank representatives emphasized the need for a strengthened IMF, minimal changes in federal bank regulatory agency and SEC reporting requirements, and a continued reliance on internal bank management controls.48

Increased funding for the IMF was achieved, but at a price to the commercial banks. As Senator Jake Garn noted, "the price of an $8.4 billion increase in the IMF authorization in Congress is going to be legislation [the International Lending Supervision Act of 1983 (the ILSA)] so that lawmakers can go home and report that 'we did not bail out the banks.'"49 Not surprisingly, major commercial banks took a dim view of this seemingly punitive approach. One bank official observed in Congressional testimony on the IMF legislation that,

While we believe the importance of the IMF to the U.S. recovery is being recognized in the Congress, we are concerned that juxtaposed with this positive development is the feeling that U.S. banks must be penalized for their international credit exposure and that the banking system should somehow be protected from itself by imposing legislative controls that would produce a more defensive and conservative approach by the banks toward levels and concentrations of international credit.50

As enacted, the ILSA provided for selective additional controls on international lending by commercial banks in the United States. While falling

48. See, for example, REP. 98–16, supra note 34, at 95 (statement of Peter C. Read, Vice President of the Bankers' Association for Foreign Trade); To Increase the U.S. Quota in the International Monetary Fund and Related Matters, Hearings Before the Subcomm. on International Trade, Investment and Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs, 98th Cong., 1st Sess. 564 (1983) [hereinafter referred to as REP. 98–17] (statement of Robert Heller, Vice President for International Economics, Bank of America).
50. REP. 98–16 supra note 34, at 100.
short of providing any comprehensive regulatory approach, the ILSA did establish new capital adequacy and reserve requirements and required the application of new accounting and reporting standards for international lending by commercial banks.

4. Accounting and Disclosure Requirements

To an extent not present in the other countries discussed in this analysis, commercial banks in the United States are subject to extensive accounting and disclosure requirements. Despite such requirements, there is a growing concern that allowing accountants to satisfy their professional responsibilities with a declaration that the financial statements of a bank or other company are presented in accordance with generally accepted accounting principles may permit banks to reveal themselves in the best, rather than in the most truthful light. The recent problems of Continental Illinois and Bank of America are general cases in point.51

Three specific items have recently been cited for special attention by federal bank regulatory agencies: (a) accounting for overdue loans and capitalization of interest, (b) accounting for fees on international loans, and (c) the contents of bank call reports.

a. Accounting for Overdue Loans and Capitalization of Interest

In June of 1984, a joint statement by the Comptroller and the FRB sought to clarify the regulators' position on accounting for loans on which interest is more than ninety days overdue. Traditionally, banks put such loans on "nonaccrual" status, which meant that banks could count interest on such loans towards earnings only when it was actually received and had to subtract from current income any interest that had been recorded but not actually collected.52

In the early 1980s, however, in connection with loans to Argentina and other Latin American countries and as a result of a certain "bending" of the existing rules, such loans had often not been put on nonaccrual status.53


52. Comptroller and FRB, Joint Policy Statement on Nonaccrual Status of Loans, FED. BANKING L. REP. (CCH) ¶ 86,017 (June 11, 1984), [hereinafter cited as Statement on Nonaccrual Status].

53. Sheshunoff & Co., an Austin, Texas bank consulting firm, estimated that as of the end of fiscal 1983, the percentage of nonperforming loans still shown as accruing interest was as follows for certain major banks: Crocker, 30.69 percent; Bank of America, 29.07 percent; Manufacturers Hanover Trust Company, 28.04 percent; Security Pacific, 21.09 percent; Continental Illinois, 20.47 percent. Other major banks, however, did not typically accrue interest on nonperforming loans: J.P. Morgan, 1.3 percent; Citicorp, 3.23 percent; Chemical Bank, 3.53 percent; Chase Manhattan, 4.94 percent; First Chicago, 5.35 percent. New Bank Rules Could Affect Domestic Loans, Wall St. J., June 20, 1984, at 4.
Under the more flexible interpretation that had been applied by many commercial banks, the determination of whether a loan should be considered nonaccruing was based on whether it was 90 days late at the end of the quarter. Under the stricter traditional interpretation, a loan was to be placed on a nonaccrual basis as soon as it was 90 days past due, regardless of the point during a fiscal quarter at which that happened.54

The joint policy statement was straightforward in its requirements:

Banks may not accrue interest on any loan when principal or interest is due and has remained unpaid for ninety days or more unless the loan is both well secured and in the process of collection;

Loans which reach nonaccrual status may not be restored to accruing status until all delinquent principal and/or interest has been brought current, or the loan becomes both well secured and in the process of collection;

The date on which a loan reaches nonaccrual status is determined by the contractual terms of the loan. If a loan reaches nonaccrual status on a date which falls between official reporting dates, it remains on nonaccrual status until it meets the criteria for restoration to accruing status.55

Similarly, there has been disagreement over the accounting treatment of capitalized interest. Traditionally, loans on which interest rates have been reduced below market rates must be shown separately on balance sheets. A more liberal accounting treatment of capitalized interest would permit continued reporting of market rates under certain circumstances.56

b. Accounting for Fees on International Loans

The ILSA imposed new requirements relating to accounting for fees on international loans. It provides in pertinent part that, “in order to avoid excessive debt service burdens on debtor countries, no banking institution shall charge, in connection with the restructuring of an international loan, any fee exceeding the administrative cost of the restructuring unless it amortizes such fee over the effective life of each such loan.”57 Subsequently,

54. The problem became acute at the end of the first quarter of 1984. See Bennett, Strict U.S. Ruling to Slash Profits of Banks That Lent to Argentina, N.Y. Times, June 19, 1984, at A1: “Thus, at the end of the first quarter, Argentina merely paid enough interest so that its loan payments were less than ninety days in arrears. That meant that, by the end of March, interest had been paid only up to the first few days of January. Nonetheless, the banks counted toward their earnings interest that had been accrued through the end of March.” See, Banks May Take Hit on Foreign Loans After Interest Accrual Rules, [Jan.–June] WASH. FIN. REP. (BNA) No. 42, at 1065 (June 25, 1984).
55. Statement on Nonaccrual Status, supra note 52.
56. How Can American Banks Account for Those Latin Loans?, ECONOMIST 87 (June 2, 1984); See also, Task Force Reported Studying Changes in Capitalization of Interest, 43 [July–Dec.] WASH. FIN. REP. (BNA) No. 43, at 41 (July 9, 1984). Capitalization of interest is not explicitly covered by existing bank regulations, but it would affect the judgment of bank regulatory agencies on the “collectibility” of a loan and thus on a loan’s classification. An interagency task force has been formed to review accounting procedures relating to the capitalization of interest.
each of the three federal bank regulatory agencies issued new regulations on accounting for international loan fees.\textsuperscript{58}

The final regulations issued by the Comptroller, the FRB and the FDIC established uniform requirements for accounting for fees associated with the restructuring of international lending arrangements and nonrefundable fees charged by banking institutions in connection with other international loans.\textsuperscript{59} They distinguished between restructured international loans and other international loans in the required accounting treatment for fees.

A "restructured loan" must meet two criteria. First, the borrower whose loan is being restructured because of debt service difficulties must be a resident of a foreign country experiencing a generalized inability of public and private sector obligors to meet their external debt obligations on a timely basis because of a lack of, or restraints on, the availability of foreign exchange in that country. Second, the terms of the loan must have been revised to extend the original schedule of payments or reduce the stated interest, or new funds must have been provided for the benefit of the borrower which have the same effect as extending the schedule of payments or reducing stated interest on the original loan. For any loan that meets these criteria, the regulations prohibit a banking institution from charging any fee unless the portion of the fee in excess of administrative costs is deferred and amortized over the effective life of the loan.\textsuperscript{60} Fees on other international loans need not be amortized but must be accounted for to accrue an appropriate portion of the fee as income over the life of the loan.\textsuperscript{61}

c. Bank Call Reports and SEC

Reporting Requirements

Most commercial banks engaged in foreign lending are subject to regular bank examinations by the appropriate federal bank regulatory agency. On a periodic basis, they are also required to prepare call reports which contain extensive information on such matters as capital adequacy, asset quality, management quality, earnings and profitability, and liquidity.\textsuperscript{62} Ratings based on performance in these categories are used to arrive at composite ratings, which are used by federal regulators as a basis for subjecting "problem" banks to greater surveillance.\textsuperscript{63}

For national banks, certain basic changes in reporting policies have been

\textsuperscript{58} The regulations were adopted as amendments to 12 C.F.R. Pts. 20, 211 and 351.


\textsuperscript{60} 12 C.F.R. §§ 20.9(a), 211.45(a) and 351.2(c) (1985).

\textsuperscript{61} 12 C.F.R. §§ 20.9(b), 211.45(b) and § 351.2(d)(1985).

\textsuperscript{62} R. DALE, BANK SUPERVISION AROUND THE WORLD 66 (Group of Thirty, 1982) [hereinafter cited as DALE, BANK SUPERVISION].

\textsuperscript{63} Id.
adopted. The Comptroller has issued a rule providing for the application of disclosure requirements for banks under its jurisdiction that are quite similar to disclosure requirements imposed by the Securities and Exchange Commission (the SEC) on reporting companies. In July of 1984, the Comptroller sought public comments on ways to revise disclosure policies to help market participants, including uninsured depositors, obtain better information about the condition of national banks.  

Of course, to a certain extent, SEC reporting requirements have long been applicable to commercial banks. Banks and bank holding companies which meet certain criteria, including either the filing of a registration statement for the public offering of securities or having more than specified minimum assets and shareholders, are subject to SEC reporting requirements. Moreover, the federal bank regulatory agencies are charged with developing and administering other disclosure requirements, which in many instances are required to be substantially similar to SEC requirements.

Prior to some significant changes in SEC reporting requirements achieved in 1983, there was dissatisfaction with disclosure rules that seemed to permit significant differences in the ways banks presented information about troubled overseas loans. Pre-1983 SEC rules were generally ineffective in providing shareholders with enough information to make realistic assessments of the riskiness of foreign lending. Securities Act Release No. 33-6478 (the SEC Disclosure Release) amended certain guidelines concerning disclosure by bank holding companies with respect to general information

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64. In an Advance Notice of Proposed Rulemaking, Disclosure of Financial and Other Information Regarding National Banks, 49 Fed. Reg. 28,566 (1984), the Comptroller requested comments on a wide range of issues concerning the disclosure system:

- What are the general characteristics of an effective disclosure system?
- Are quarterly bank call reports an appropriate mechanism to disclose information to the marketplace?
- Should certain items be exempt from disclosure requirements?
- Should all financial statements that national banks prepare be audited by independent public accountants?
- Should the Comptroller adopt rules of practice similar to those adopted by the SEC enabling that agency to discipline accountants who prepare financial statements?


65. See Section 12(i) of the Securities Exchange Act of 1934; see also, Coombe & Lapic, Problem Loans, Foreign Outstandings, and Other Developments in Bank Disclosure, 40 BUS. LAW. 485, 513 (1985) (considerable progress has already been made in harmonizing bank regulatory agency and SEC disclosure requirements).

about nonaccrual, past due and restructured loans, potential problem loans, foreign outstandings and loan concentrations. The guidelines, which are set forth at Guide 3 to Regulation S-K, require that nonaccrual, past due and restructured loans be separately identified.

A first category requires that policies with respect to placing loans on nonaccrual status be discussed. A second category of required disclosure consists of loans that are still on an accrual basis but are ninety days past due as to either principal or interest payments. A third category consists of accrual basis loans that are not ninety days past due but are troubled debt restructurings.

The SEC Disclosure Release also clarified the applicability of Statement of Financial Accounting Standards No. 15 (FASB 15) and Staff Accounting Bulletin Nos. 49 and 49A (together, SAB 49). FASB 15 provides in pertinent part that a restructuring of debt constitutes a "troubled debt restructuring" if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. SAB 49 requires certain disclosures about negotiations with debtor countries by bank holding companies filing reports required by the Securities Act or the Securities Exchange Act. Subsequently, the SEC issued some more specific guidelines with respect to the reporting of restructured Argentine debt.

B. Regulations and Ratios

1. Loans to Single Borrowers

12 U.S.C. § 84(a)(1) provides that the total loans and extensions of credit by a national banking association to a "person" outstanding at one time and

67. Securities Act Release No. 6478, 48 Fed. Reg. 37,609 (1983), set forth at 17 C.F.R. §§ 210, 229, 231 and 241. These amendments revised existing guidelines dealing with nonperforming loans to focus more broadly on the various risk elements involved in lending activities. They are applicable to filings containing financial statements for fiscal years ending on or after Dec. 31, 1983.

68. For a comprehensive discussion of revised Guide 3, see Coombe & Lapic, supra note 65, at 502-512.


70. SAB 49 provides that the disclosure should include a discussion of the nature of such negotiations and a general description of (a) any agreements to extend payments or reduce interest, (b) any commitments to extend additional borrowings to the foreign country and (c) any other arrangements, such as agreements to maintain deposits with government banks.

71. The guidelines were set forth in a letter dated Dec. 28, 1984, from John J. Huber, Director of the SEC Division of Corporation Finance, to Robert Dineen, Esq., of Shearman & Sterling, New York City.
not fully secured by collateral shall not exceed 15 percent of the unimpaired capital and surplus of the association. 12 C.F.R. § 32.5(d)(1) provides that loans or extensions of credit to foreign governments, their agencies and instrumentalities will be combined with one another under section 84 only if they fail to meet either of two tests at the time the loan or extension of credit is made: (1) the borrower has resources or revenues of its own sufficient over time to service its debt obligations (the "means" test) and (2) the purpose of the loan or extension of credit is consistent with the purpose of the borrower's general business (the "purpose" test). Pursuant to 12 U.S.C. § 324, similar limits are imposed on state member banks.

2. Capital Adequacy

Explicit focus on capital ratios has been a relatively recent development in U.S. bank regulation. In late 1981, the FRB and the Comptroller identified two distinct types of capital to which they would direct regulatory attention. Primary capital consists of common stock, perpetual preferred stock, surplus, undivided profits, contingency and other capital reserves, mandatory convertible securities and the allowance for possible loan losses. Total capital consists of primary capital plus limited-life preferred stock and bank subordinated debt.

One result of the ILSA has been the attempt to impose minimum capital adequacy ratios on commercial banks. In July 1984, in separate statements, the FRB, the FDIC and the Comptroller announced their intentions of raising primary capital requirements (guidelines in the case of the FRB) to 5.5 percent of total assets for large commercial banks. Formerly, FRB and Comptroller guidelines were 5 percent for large commercial banks and 6

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72. 12 C.F.R. § 32.5(d)(2) provides that in order to show that the "means" test and the "purpose" test have been satisfied, a bank must retain certain information in its files. The required information is to include a statement describing the legal status and degree of financial and operational autonomy of the borrowing entity. For a general discussion of lending limits for national banks, see K. J. Rojc, National Bank Lending Limits—A New Framework, 40 Bus. Law. 903 (1985).

73. S. Talley, Bank Capital Trends and Financing, FRB Staff Study No. 122, at 1 (February 1983).

74. The provisions with respect to capital adequacy are set forth at 12 U.S.C. § 3907.

75. The FDIC proposed rule on capital adequacy standards for banks is set forth at 49 Fed. Reg. 29,399 (1984); the Comptroller's proposed regulation on capital requirements is set forth at 49 Fed. Reg. 34,838 (1984); a statement of the proposed FRB guidelines is set forth at 49 Fed. Reg. 30,317 (1984). According to figures compiled by Dean Witter Reynolds Inc., primary capital ratios as of March 31, 1984 for certain major commercial banks were as follows: Bank America, 5.04 percent; Bankers Trust, 5.51 percent; Chase Manhattan, 5.55 percent; Chemical New York, 5.15 percent; Citicorp, 5.09 percent; Continental Illinois, 5.54 percent; First Chicago, 5.96 percent; Manufacturers Hanover, 5.46 percent; and J. P. Morgan, 6.95 percent; Research Note-Financial Group, Primary Capital: Banking Regulations, June 24, 1984. See also the slightly different figures set forth at Taylor, Fed Calls for Capital Ratio Boost for Banks, Fin. Times, July 24, 1984, at 3.
percent for community banks with assets of less than $1 billion. On February 11, 1985, the FDIC approved a final rule raising primary capital requirements to 5.5 percent of total assets. The Comptroller approved a similar rule on March 11, 1985 and the FRB has approved guidelines setting identical minimum capital requirements.

Actually, the three federal bank regulatory agencies have long had the goal of establishing uniform capital adequacy ratios for all commercial banks, but they have differed over the levels at which the standard should be set. The differences were apparent in the July 1984 formulations of proposed rules. Most importantly, the FRB proposed that the new capital adequacy ratios be stated as guidelines rather than rules. As adopted, the FRB guidelines retained the "zone concept" and included financial factors other than capital ratios in considering the "zone" classification of a banking institution.

76. FDIC Proposes Mandatory Capital Rules; Fed and OCC Expected to Follow, [July-Dec.] WASH. FIN. REP. (BNA) No. 43, at 97 (July 16, 1984). In December of 1981, the FRB and the Comptroller adopted capital adequacy guidelines for national and state member banks and bank holding companies. In Dec. 1983, the FRB reaffirmed these capital adequacy ratios (49 Fed. Reg. 794 (1983)) and incorporated them as Appendix A to Regulation Y, 12 C.F.R. Part 225. Even before the introduction of new guidelines, capital asset ratios of major commercial banks in the U.S. compared favorably with those of the Federal Republic of Germany and the United Kingdom, although they were below those of Switzerland: Federal Republic of Germany, 3.31; Switzerland, largest five banks, 5.52, all banks, 5.19; United Kingdom, largest four banks, 4.80, all banks, 4.14; United States, largest 10 banks, 4.93, largest 25 banks, 5.09; see R. WILLIAMS, INTERNATIONAL CAPITAL MARKETS, DEVELOPMENTS AND PROSPECTS (IMF, 1983) Table 6: Capital-Asset Ratios of Banks in Major Capital Market Countries, 1977-1982 (calculated by IMF Staff), at 8. Because of differing definitions and statistical measurements, comparisons of the capital positions of banks in different countries are extremely difficult. Some countries allow banks to establish hidden reserves by writing down particular assets or carrying others below market value. While hidden reserves are not permitted in the U.S., certain common accounting practices have a similar effect. Hertzberg, Some Agile U.S. Banks Can Balance Books and Show Profit Rise by Financial Juggling, Wall St. J., Jan. 20, 1984, at 9 (European edition). Hertzberg notes that U.S. commercial banks sometimes create one-time profits by selling assets that they have acquired when refinancing the debts of troubled corporate borrowers. Banks may accept securities in return for writing off debt. Then, if the financial position of the borrower improves, the market value of such securities may rise rapidly. U.S. banks may have hidden losses because no writing down of assets to market or implicit market value is required. Unrealized appreciation (really hidden reserves) might occur in connection with real estate used for bank operations. H. WALLICH, statement in The International Debt Problem and Its Impact on Finance and Trade, 318 PLI COMMERCIAL LAW AND PRACTICE HANDBOOK, 64 (B. Campbell & R. Herzstein, eds. 1984).


80. Id.; for an analysis questioning the validity and utility of capital ratios generally in analyzing bank safety and soundness, see J. Mingo, Capital Ratios: The Reg Q Fiasco of the Future, BANKING EXPANSION REP., Jan. 21, 1985, at 1.
Regulatory concern has also been directed to the inclusion of so-called “off balance sheet items” in measures of capital adequacy. The Comptroller has been considering the imposition of higher capital requirements on institutions which have low levels of liquid assets such as Treasury bills or significant off balance sheet activities such as standby letters of credit which are not reflected in existing minimum bank primary capital ratios. In July 1985, FRB Chairman Paul Volcker suggested the adoption of risk-based capital rules which would force banks to supplement their capital reserves for riskier activities, such as a large number of off balance sheet items or problem loans.81

3. Liquidity

The three federal regulators have not attempted to impose standard requirements for liquidity ratios. However, evaluation of a commercial bank’s liquidity position is a normal part of the bank examination process. In general terms, the regulatory agencies consider a commercial bank’s liquidity position with respect to such matters as (a) volatility of deposits, (b) availability of readily marketable assets or assets convertible into cash, (c) the technical competence of bank personnel, (d) reliance on interest-sensitive funds, and (e) access to money markets.82

4. Foreign Exchange Exposure

12 C.F.R. § 20.5(a) states that each national bank and Federal branch or agency of a foreign bank, which for its own account has assets, liabilities or positions in any of certain foreign currencies in excess of a specified dollar amount, must file the so-called “Monthly Consolidated Foreign Currency Report.”83 Pursuant to the International Investment Survey Act of 1976,84 and to provide information requested by the IMF in accordance with section 8(a) of the Bretton Woods Act,85 every person (including banking institutions) engaging (a) in specified transactions in foreign exchange or (b) in specified transfers of credit between any person within the United States and

81. Paul Taylor, ‘High-Risk’ U.S. Banks May Face New Curbs, Fin. Times, Apr. 16, 1985, at 1; M. Langley and L. McGinley, Higher Capital to Cover Risk Urged for Banks, Wall St. J., July 19, 1985, at 5. Examples of off balance sheet “contingent liabilities” that have been suggested for inclusion in a risk capital measurement include: (a) note issuance facilities and revolving underwriting facilities (“NIFs” and “RUFs”); (b) interest rate swaps; (c) standby letters of credit, and (d) sales with recourse. For a discussion, see C. Reichardt, Getting Caught Off Balance By Hidden Risks, AM. BANKER, June 20, 1985, at 4.

82. DALE, BANK SUPERVISION, supra note 62, at 64; see, for example, The Comptroller’s Manual for National Bank Examiners at sections 203, 301, 405, 503, and 600.

83. Form FFIEC 035.


any person outside of the United States, is required to furnish certain information on prescribed report forms.\textsuperscript{86}

C. Supervision of International Lending

1. Country Risk and Provisions for Loan Losses

Country risk\textsuperscript{87} supervision and provisions for loan losses\textsuperscript{88} are among the most controversial aspects of federal regulatory policy with respect to international lending. Prior to 1977, there were significant differences among the regulatory agencies in their approaches to supervising country risk exposure. In 1977, the Comptroller, the FRB and the FDIC began collecting a "Uniform Country Exposure Lending Survey" on a semi-annual basis.\textsuperscript{89} In 1978, joint examination procedures were adopted with a view towards encouraging diversification of loan portfolios, identifying problem credits subject to transfer risk and large country concentrations of loans, and evaluating the extent to which banks had satisfactory systems for monitoring country exposure and assessing country risk.\textsuperscript{90}

The joint examination procedures adopted in 1978 included the creation of the Interagency Country Exposure Review Committee (ICERC), composed of representatives of the Comptroller, the FRB and the FDIC. ICERC meets three times a year and considers about twenty countries at each meeting, evaluating their current economic situation and future economic prospects.\textsuperscript{91} The ICERC country risk examination system consists of: (a) identifying countries with actual, imminent and potential debt servicing problems, (b) citing loans to countries with actual or imminent debt prob-

\begin{itemize}
\item \textsuperscript{86} 31 C.F.R. § 128.2 (1985).
\item \textsuperscript{87} The FRB has stated that country risk is comprised of legal, economic, political and social factors that accompany lending to foreign economic entities whose payment ability may be affected by the actions of foreign states. It includes risk associated with “political or social upheaval, nationalization or appropriation, government repudiation of external debts, exchange controls, or foreign exchange shortfalls.” \textit{A New Supervisory Approach to Foreign Lending}, FRBNY Q. Rev. 1–2 (Spring 1978).
\item \textsuperscript{88} Regulation S-X requires bank financial statements to include the allowance for loan losses and the provision for loan losses. 17 C.F.R. §§ 210.9-03(7), 210.9-04(11) (1985). See Coombe and Lapić, \textit{supra} note 65, at 502–503.
\item \textsuperscript{89} Since 1979, aggregate data from country exposure reports have been published regularly by the three supervisory agencies. As Pecchioli notes, "such aggregate surveys provide a comprehensive picture of the U.S. banking system's overall exposure to individual foreign countries by location of claims and country of ultimate risk." R. PECCHIOLI, \textit{The Internationalization of Banking} 90, n. 21 (OECD, 1983).
\item \textsuperscript{90} See generally, \textit{A New Supervisory Approach to Foreign Lending}, \textit{supra} note 87, at 1–6; Rep. 98-16, \textit{supra} note 62, at 332 (statement of J. Charles Partee).
\end{itemize}
lems for the attention of bank management in examination reports, (c) including "special comments" in bank examination reports when loans to countries with potential debt problems exceed certain levels in relation to bank capital, and (d) evaluating the internal systems used by banks to manage country exposures.92

The issues of country risk and reserves against possible loan losses have been the subject of a "Joint Memorandum" of the Comptroller, the FRB and the FDIC.93 It outlined a five-point program, including measures to strengthen the existing program of country risk examination, evaluation and disclosure. It also recommended the establishment of a system of special reserves against possible loan losses in countries of apparently high risk.94 Some of the measures suggested in the Joint Memorandum were adopted as regulations implementing the ILSA.95

The Joint Memorandum stated that "banks should make public disclosure of all concentrations of country exposure that are material."96 Reflecting this determination, a Country Exposure Report (CER), developed pursuant to FFIEC guidelines, must be filed by commercial banks if they have a foreign branch or subsidiary, an Edge or Agreement Corporation, or a Puerto Rico or U.S. possession branch and consolidated claims against foreign residents that exceed twenty million dollars.97 Assets to be reported on the CER include loans and securities, as well as a number of other items.98 CERs must be filed within forty-five days of the end of each quarter.99

While all data on the CER is confidential, a public Country Exposure Information Report must also be filed. It must contain information on

92. Procedures of ICERC have not generally been made public and are, of course, designed to supplement rather than supplant the independent country risk analysis conducted by commercial banks. However, ICERC is more heavily involved in country risk analysis per se than are its regulatory counterparts in the other creditor countries discussed herein. According to DALE, BANK SUPERVISION, supra note 62, at 65, ICERC at its three meetings each year "votes either to classify loans to a particular country or to designate countries as strong, moderately strong or weak. The country designation determines the prudent exposure limit relative to capital and therefore provides a basis for limiting loans." See also Rep. 98-16, supra note 34, at 17-18 (statement of Charles A. Bowsher).


94. The very modest provisions for loan losses in the U.S. were certainly a factor influencing the Joint Memorandum's call for more generous reserves.

95. The ILSA provided that the federal bank regulatory agencies should issue rules requiring banks under their jurisdiction to set aside special reserves for certain loans, to amortize loan rescheduling fees over the life of a loan and to maintain adequate capital levels.

96. Joint Memorandum, supra note 93, at 5.

97. FFIEC Form 009.

98. FFIEC Form 009, Instructions at pts. III(A) and (F).

99. FFIEC Form 009, Instructions at pt. II(C).
"exposures" that exceed the lesser of .75 percent of total assets or 15 percent of primary capital to any one country. In early February of 1984, the Comptroller, the FRB and the FDIC issued final regulations on the reporting and disclosure of international assets. Pursuant to the final regulations, each "banking institution" is required to submit to its primary federal banking supervisor, at least quarterly, information on the amount and composition of its international assets that are "material" in relation to its total assets and to capital.

Other regulations, which implement section 905(a) of the ILSA, require banking institutions to establish special reserves, so-called allocated transfer risk reserves or "ATRRs", against the risk presented in certain international assets when the appropriate federal banking agency determines that specified conditions, including impairment of a bank’s assets by a "protracted inability" of public or private debtors in a foreign country to make payments on their external debt, exist. Alternatively, the regulations provide that a bank need not establish an ATRR if it writes down the value of the specified international assets. There are also certain circumstances involving new lending under which ATRRs can be avoided. There is no requirement that an ATRR be established when an IMF or similar economic adjustment program is being followed and it can be demonstrated that new lending would enhance the debt-servicing capacity of a given country.

2. Lender of Last Resort

Expectations concerning the lender of last resort function are central to an efficient international financial system. In the United States, this function has been explicitly assumed by the Federal Reserve System and the FDIC, depending on the nature of the crisis.

102. The regulations were prompted by the ILSA, which required the federal banking agencies to promulgate regulations requiring banking institutions with foreign country exposure to submit information regarding such exposure at least four times a year. 12 U.S.C.A. § 3906 (Supp. 1985).
104. 12 C.F.R. §§ 20.8(c)(4), 211.43(c)(4) and 351.1(b)(3)(iv) (1985). To date, the ATRR provisions have been applied only to Zaire, the Sudan, Poland, Nicaragua and Bolivia. M. Langley, Regulator Lists Countries Whose Loans Require Special Reserves at U.S. Banks, Wall St. J., July 24, 1985.
106. For a useful summary of the ways in which lender of last resort functions are exercised by the Federal Reserve System and by the FDIC, see DALE, BANK SUPERVISION, supra note 62, at 67-68.
Any bank which maintains reserves with the appropriate Federal Reserve Bank is entitled to make use of the Federal Reserve System's statutory lending powers to discount eligible paper or to make advances secured by satisfactory collateral. Pursuant to section 7 of the IBA, such advances could be made to any branch or agency of a foreign bank that maintains reserves under the Federal Reserve System. In addition, the Federal Reserve System could be expected to provide indirect liquidity assistance to foreign establishments of United States banks by channeling credit through the United States parent bank's office.

True insolvency would result in performance of the lender of last resort function by the FDIC. The FDIC has a number of options in such cases. First, it could provide insurance payments to the depositors of a failed institution. Second, it could invite bids from solvent banks to assume deposit liabilities and certain assets of a failed bank. Third, it could provide direct financial assistance to a bank which is in danger of closing. In addition, a solvency crisis might require the injection of permanent new capital by other banks, the Federal Reserve System or even the federal government.

3. Treatment of Branches and Subsidiaries of U.S. Banks Operating Abroad

Sections 25 and 25(a) of the Federal Reserve Act and section 4(c)(13) of the Bank Holding Company Act give U.S. banking organizations the legal authority to operate abroad. The specific terms and conditions are determined by the FRB and are descried in Regulation K. Generally accepted accounting principles, SEC requirements and FRB requirements all insure that consolidated accounting procedures will be followed with respect to branches and majority-owned subsidiaries. Capital ratios apply on a consolidated basis, but consideration would be given to the fact that under certain circumstances foreign branches and subsidiaries of U.S. banks would be permitted to engage in riskier activities than the parent bank. Regulation K supports these supervisory efforts by requiring that a U.S. banking organization must obtain approval from the FRB before acquiring or estab-

107. DALE, INTERNATIONAL BANKING, supra note 105, at 153.
108. One observer suggests that true insolvency might arise when the amount of bad debts which must be written off exceeds the equity capital of the bank in question. Brittan, Problems of Last Resort Lenders, Fin. Times, May 24, 1984, at 25.
109. Id.
110. Sections 25 and 25(a) of the Federal Reserve Act concern the operations of Edge and Agreement corporations. Section 4(c)(13) of the Bank Holding Company Act of 1956 (12 U.S.C. § 1843(c)(13)) governs certain overseas activities of bank holding companies. The FRB has implemented these statutory provisions in Regulation K.
111. DALE, INTERNATIONAL BANKING, supra note 105, at 131.
lishing a foreign subsidiary and must maintain sufficient information on the activities of each foreign subsidiary to permit an examination of its affairs from the U.S. office of the parent. Thus, the bank examination process covers branches and (to a lesser extent partially dependent on local laws) subsidiaries of U.S. banks. However, despite some recent changes, it is still the case that foreign branches and subsidiaries of the United States banks are currently treated differently from United States headquarters.

4. Treatment of Foreign Banks in the U.S.

The International Banking Act of 1978 (the IBA) created a federal supervisory authority and regulatory structure for United States branches and agencies of foreign banks, which had previously been regulated almost entirely by the states. With certain exceptions appropriate to the nature and extent of their activities, the general rule is that U.S. branches and subsidiaries of foreign banks are subject to the reporting requirements that apply to U.S. banks. Pursuant to the terms of the Bank Holding Company Act of 1956 (the BHCA), the FRB also imposes extensive reporting requirements relating to the financial structure and condition of the parent bank. At present, while there are some significant differences between standards applied to foreign banks and domestic banks, the federal bank regulatory agencies have taken steps to conform requirements applicable to foreign banks operating in the United States to those applicable to domestic banks.

In December of 1984, the FDIC revised the existing asset pledge and asset maintenance requirements for insured branches, set limits on concentrations of transfer risk and began to require a minimum capital adequacy ledger account evidencing funding of the branch by the parent in lieu of

112. Houpt and Martinson, supra note 1, at 15.
113. Dale, International Banking, supra note 105, at 133.
115. Dale, International Banking, supra note 105, at 133-134. In addition, a number of special reporting requirements are applicable. For example, FFIEC Form 002, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, must be filed quarterly with the appropriate district Federal Reserve Bank. See G. Lindstrom and G. Pfund, United States, in International Bank Accounting, 38 (Ernst & Whinney eds. 1985) [hereinafter International Bank Accounting.]
116. The FRB requires foreign banks that operate branches or agencies in the U.S. or foreign bank holding companies that operate subsidiaries in the U.S. to file Form F.R. Y-7, Annual Report of Foreign Banking Organizations.
117. Foreign banks seeking to establish branches, agencies or subsidiaries under state or federal license are subject to the same chartering criteria and procedures as are domestic banks. For a discussion of section 4 of the IBA, see S. J. Weiss, The Competitive Balance Between Domestic and Foreign Banks in the United States, Comptroller of the Currency Staff Paper, at 43 (1980).
existing asset maintenance rules. The amendments implemented the deposit insurance provisions of the IBA and emphasized the FDIC's intent that there be an equivalent for capital in insured branches. On February 11, 1985, the FDIC adopted a final regulation increasing total capital requirements for nonmember banks and insured branches of foreign banks from five to six percent.

The FFIEC has made changes in the reports required of United States branches and agencies of foreign banks. Recently adopted changes alter the form and substance of required reports of assets and liabilities and provide greater conformity with information provided by United States banks in quarterly call reports. Other proposed changes would require each branch or agency that had more than thirty million dollars in total direct claims on residents of foreign countries to provide certain "country risk" information on the exposure of such branch or agency to its home country and to the five other countries to which its exposure is greatest.

5. Attitudes Towards International Cooperation

The ILSA directed the federal bank regulatory agencies to consult with supervisory authorities of other countries to coordinate and improve inter-

118. Differences between foreign banks and domestic banks, particularly in the area of capital adequacy requirements, have also been of concern to the FRB. See, for example, FRB, Application of Fuji Bank Ltd. (Tokyo) to acquire Walter E. Heller & Co. (Chicago), approved Dec. 20, 1983. In the Fuji Bank decision, the FRB expressed concern about the comparatively low capital ratios of foreign banking organizations operating in the United States. It noted that Fuji Bank's publicly reported primary capital ratio was "well below the Board's guidelines for U.S. multinational bank holding companies." See also The Mitsubishi Bank, Limited, 70 Fed. Res. Bull. 518 (June 1984); Bank of Montreal, 70 Fed. Res. Bull. 664 (Aug. 1984); and FRB Order, December 18, 1984, approving the application of The Sanwa Bank Limited, Osaka, Japan to acquire from Continental Illinois Corporation, Chicago, Illinois, the shares of Cobak Corporation and Continental Illinois Leasing Corporation. The FRB noted that The Sanwa Bank's primary capital ratio was well below the capital guidelines for U.S. multinational bank holding companies. Foreign Bank Capital Continues to Disturb Central Bank, BANKING EXPANSION RTPR., Jan. 21, 1985, at 7.


121. FFIEC Release, proposed Rule on Reporting Foreign Country Exposure by U.S. Branches and Agencies of Foreign Banks, 50 Fed. Reg. 2,722 (1985). The information that United States branches and agencies of foreign banks are required to provide includes the following: selected income data including provisions for loan losses; quarterly averages of selected asset liability accounts; and reports on contingencies and commitments, such as commitments to make and purchase loans, acceptances, and standby letters of credit. In addition, such foreign branches and agencies will be required to submit information on their past due, nonaccrual and renegotiated loans on the same type of form on which U.S. banks now report this information.
national lending supervision. The argument supporting the statutory requirement is that international coordination of bank supervision is increasingly important in a period when banks of many countries make loans to the same borrower and the quality of each bank’s loans is affected by debt subsequently incurred from other sources.

Attitudes of commercial banks and federal bank regulatory agencies towards international supervision and cooperation have not always been clearly expressed, although there now appears to be a common willingness to explore greater international cooperation in the future. Recently, as the May 1984 meetings sponsored by the Federal Reserve Bank of New York suggest, there has been a reconsideration of the appropriateness of international supervisory initiatives that would previously have been viewed as unnecessary by commercial banks and redundant by bank supervisory agencies.

III. Bank Regulation and Supervision in the United Kingdom

A. Generally

The approach to bank supervision in the United Kingdom contrasts with the rule-based and frequently adversarial system that has developed in the U.S. It is based on cooperation and frequent consultation between the Bank of England and commercial banks, with a relatively limited supervisory role assumed by H.M. Treasury. The supervisory system has developed on a framework of prudential guidelines and extensive general reporting requirements rather than specific rules. One observer has described the United Kingdom banking system as the “least regulated in the world.”

George Blunden, a former Head of Banking Supervision at the Bank of England, characterized the U.K. bank supervisory system as “personal, participative, progressive and flexible.” In explaining that statement, W. P. Cooke, the incumbent official, has observed that U.K. bank supervision emphasizes frequent and extensive discussions between the Bank of England and the senior management of commercial banks. A fundamental precept of the Bank of England’s approach to supervision is that the banking

122. 12 U.S.C.A. §§ 3901(a)(2), 3901(b) (Supp. 1985). 12 U.S.C. § 3901(b) provides that: “The Federal banking agencies shall consult with the banking supervisory authorities of other countries to reach understandings aimed at achieving the adoption of effective and consistent supervisory practices with respect to international lending.”


system should be able, subject to the satisfaction of basic prudential guidelines, to accommodate rather than restrict different kinds of banking business. In Cooke's words,

We have a supervisory system with authorization deriving from statute but the running of the system still depending to a large degree on moral suasion. Powers exist to reinforce the system, but not so draconian as to leave no room for debate, reasoned discussion and persuasion—of banks by supervisors and vice-versa.\(^{125}\)

Recently, the application of this basic supervisory philosophy has been criticized. While emphasizing that the flexibility of the present system should be retained, a committee (the 1985 Review Committee) chaired by the Governor of the Bank of England identified some specific areas for change. The 1985 Review Committee recommended an improvement in the "capacity of the supervisors to exercise the crucial qualitative judgments on the management, the loan books, the adequacy of capital and other elements of the business of banks which they are supervising."\(^{126}\)

The collapse of Johnson Matthey Bankers (JMB) was the background factor supporting the work of the 1985 Review Committee. At the time of its collapse, JMB was one of five major participants in the sensitive and influential London gold market. Because the major participants in the London market do a substantial amount of business with each other, the failure of any of them affects the entire London gold market, which is arguably the most important in the world. The Bank of England intervened and subsequently took over JMB because of its belief that the pressures likely to have been put on the other four members of the market could quickly have been transmitted to other banks in the United Kingdom and abroad.\(^{127}\) One editorial concluded that "it is hard to avoid the conclusion that the crash of [JMB] was a disaster that was waiting to happen in the context of the Bank of England's slow-moving and insensitive supervisory system."\(^{128}\)

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125. Id., at 9. One study raised some questions about the Bank of England's powers of "moral suasion." Wilson, Report of the Committee to Review the Functioning of Financial Institutions ¶ 1262 (June 1980) (Chairman: The Right Honourable Sir Harold Wilson) [hereinafter cited as the Wilson Report]. The Wilson Report stated that "serious concern has ... been expressed in evidence to us that the close relationship of the Bank to market participants may, on occasion, conflict with its obligation to provide disinterested advice to government."


1. The U.K. Banking Act

The Banking Act of 1979 (the U.K. Banking Act),\(^{129}\) which for the first time provided a statutory basis for banking supervision within the United Kingdom, was drafted in response to the so-called "secondary banking crisis" of 1973–1974\(^{130}\) and the harmonization requirements of the 1977 EEC Banking Directive.\(^{131}\) Prior to the passage of the U.K. Banking Act, the Bank of England had exercised its supervisory role largely on the basis of tradition. The U.K. Banking Act imposes on the Bank of England primary responsibility for regulating and supervising recognized banks and licensed deposit-takers, which are treated quite differently by the statutory scheme.\(^{132}\) The U.K. Banking Act provides only the basic outlines of a supervisory framework and its generality is clearly by design. In commenting on the proposed act in 1978, a representative of the Bank of England stated that, "The existing pattern of banking supervision has major elements which in the Bank's view have proved their worth within the structure of the U.K. financial system and it is intended that the proposed new statutory framework should enable them to be preserved."\(^{133}\)

Chancellor of the Exchequer Nigel Lawson has recently introduced a bill in Parliament to strengthen the supervisory framework first established by the U.K. Banking Act. The proposed measures were based upon the recommendations made by the 1985 Review Committee and include a number of significant changes. Among the major reforms to be considered are the end of the two tier system of "recognized banks" and "licensed deposit-takers" and the establishment of a regular dialogue between the Bank of England and bank auditors.\(^{134}\) As explained below, bank auditors may not at present communicate directly with the Bank of England because of the confidentiality clause of the Banking Act.\(^{135}\) Other proposed changes include limits on banks' exposures to single borrowers and strengthening internal control and reporting requirements.


\(^{133}\) Blackhurst, supra note 123, at 6.


\(^{135}\) See C. Wolman, Bank Calls For Wider Disclosure By Auditors, Fin. Times, Aug. 21,
2. The Bank of England and H.M. Treasury

The Bank of England has a very wide range of functions, perhaps broader than those of the central bank of any of the other creditor countries discussed here.136 Pursuant to the Bank of England Act of 1946 (the Bank of England Act), the Bank of England has extensive powers to request information from and make recommendations to banks, and may, with the consent of H.M. Treasury, issue directions to any bank to effect compliance with such a request or recommendation.137

Pursuant to the terms of the U.K. Banking Act, the powers of the Bank of England are quite different with respect to the two categories of “recognized banks” and “licensed deposit-takers.” A more rigorous scheme of supervision applies to licensed deposit-taking institutions. For example, section 16 of the U.K. Banking Act empowers the Bank of England to require licensed deposit-takers to provide “such information as the Bank may reasonably require about the nature and conduct of the institution’s business and its plan for future development.”138 Moreover, section 17 of the U.K. Banking Act permits the Bank of England to appoint investigators “to investigate and report to the Bank on the . . . conduct of the business of the bank or institution concerned, or any particular aspect of that business.”139

In practice, the Bank of England supervises banks by obtaining regular and detailed information on individual banks’ balance sheets and profit and loss accounts rather than through on-site examinations. This information provides the basis for regular prudential discussions with the senior management of commercial banks on the conduct of their business.140 Over time, each bank develops an individual relationship with the Bank of England. “Flexibility” and “accessibility” are words often used to describe the Bank of England’s regulatory philosophy.141

The Bank of England is owned by H.M. Treasury, which is also a part of the general supervisory framework.142 The Bank of England Act gives H.M.

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136. WILSON REPORT, supra note 125, at ¶ 1260. The Bank of England is managed by a Court of Directors comprised of the Governor, Deputy Governor and sixteen directors, all of whom are appointed by the Crown on the advice of the Prime Minister.

137. WELCH, supra note 132, at 228. The influence of “moral suasion” by the Bank of England is such that “this power to give a direction has never been used, and indeed the Bank has never explicitly based any request or recommendation on the [Bank of England Act].” Id.


139. U.K. Banking Act, supra note 129, at section 17(1).


141. Blackhurst, supra note 123, at 6.

142. In exercising its supervisory duties under the Banking Act, the Bank of England reports to Parliament through the Chancellor of the Exchequer.
Treasury a general right to issue directives to the Bank of England when H.M. Treasury believes that the public interest demands such action. This power has never been used, but it is the underlying basis of the Bank of England's ultimate subordination to the government. In Parliament, the Chancellor of the Exchequer is required to answer questions relating to the Bank of England. This is the basis of the requirement in the U.K. Banking Act that the Bank of England prepare annual reports for presentation to the Chancellor of the Exchequer. While H.M. Treasury is not involved in the day-to-day operations of the Bank of England, the public expects it to have answers to questions relating to the Bank of England in a crisis situation.

3. Commercial Banks and the Supervisory Process

U.K. commercial banks generally anticipate increased supervision of their international lending policies by the Bank of England in the near future. One prominent commercial banker has stated that, "the current difficulties faced by U.S. and European banks must increase the prospect of further moves by regulators, particularly in relation to international lending and provisions against doubtful loans." Commercial bank officials typically express a very high regard for the Bank of England and tend to view supervision and regulation as a joint and cooperative matter. With respect to international lending, commercial banks view their own internal controls as strict and also emphasize that the Bank of England has performed a particularly useful role by "persuading" banks to follow prudent policies rather than by "imposing" specific requirements. They often contrast this approach with the rule-based regulatory system of the United States.

4. Accounting and Disclosure Requirements

In the U.K., accounting rules apply uniformly to all banks and companies and there are no special rules for banks. The form and content of financial

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143. WILSON REPORT, supra note 125, at ¶ 1264. In certain of its roles, the Bank of England acts as the agent of H.M. Treasury, either under explicit statutory authority or by long-standing convention. Of course, in other matters, primarily those stemming from its function as banker to commercial banks, the Bank of England acts as principal. WILSON REPORT, supra note 125, at ¶ 1265.

144. Interviews with senior officials of major commercial banks, London, Jan. 19, 20, 23, 24 and 27, 1984; May 28 and 29, 1985 (notes on file with author). Interviews with officials in the U.K., as well as in other countries whose supervisory policies are discussed herein, were conducted on a confidential basis.

145. T. H. Bevan, Speech, Oct. 1982, reprinted in 58 BARCLAYS REV. 13 (1983). Bevan also expressed the view that supervision in relation to levels of country risk exposure was likely to increase. Id. at 14.

146. Interviews, supra note 144.

147. Id.
statements of banks are governed by: (1) the Companies Acts, (2) so-called Statements of Standard Accounting Practices (SSAPs) developed by various professional accounting bodies, and (3) banking industry custom.\textsuperscript{148} Requirements in the Companies Acts were never drawn up with the specific case of banks in mind and there are, to date, no SSAPs that relate specifically to banks. Banking industry custom has been tolerant of varying approaches and the result has been "widely differing levels of disclosure" among banks.\textsuperscript{149}

Of the three sources of influence on the presentation of financial information noted above, the Companies Acts have been the primary source of diverse regulatory standards. Previously, pursuant to the Companies Act 1981, all recognized banks and licensed deposit-taking institutions could choose to prepare accounts either in accordance with the rules of Schedule 1 to the Companies Act 1981 or the older rules set forth at Schedule 8A to the Companies Act 1948. Schedule 8A was the more popular approach because it permitted some banks to utilize a number of disclosure options, including non-disclosure of certain movements in their reserves and changes in the market value of listed investments. The Companies Act 1985, effective July 1, 1985, attempts to apply more uniform accounting standards for recognized banks and licensed deposit-taking institutions.\textsuperscript{150}

The U.K. Banking Act states that (in cases of apparent serious financial difficulties in a bank) the Bank of England may appoint competent persons to investigate its business.\textsuperscript{151} Banks, like all other registered companies in the United Kingdom, must file copies of their annual financial accounts with the Registrar of Companies.\textsuperscript{152} The U.K. Banking Act further requires all banks to maintain copies of their most recent audited accounts for public inspection.\textsuperscript{153}

U.K. accounting and disclosure rules have been criticized sharply by some observers.\textsuperscript{154} One stated shortcoming is that while audited accounts play a prominent role in U.K. supervision, the Bank of England cannot, in the absence of special circumstances, discuss an auditor's report directly with the auditor who prepared it. Moreover, because of the confidentiality

\begin{enumerate}
\item \textsuperscript{148} Institute of Chartered Accountants, Banks: An Accounting and Auditing Guide 27 (1983) [hereinafter cited as Institute of Chartered Accountants].
\item \textsuperscript{149} Id.
\item \textsuperscript{150} Companies Act 1985, II Palmer's Company L. Rep. (London); Institute of Chartered Accountants, supra note 148.
\item \textsuperscript{151} U.K. Banking Act, supra note 129, at section 17(1); Bank Supervision in the Group of Ten, supra note 140, at 99.
\item \textsuperscript{152} The Companies Act of 1985 requires all companies incorporated in the United Kingdom, including banks, to prepare an annual consolidated balance sheet and a statement of income.
\item \textsuperscript{153} U.K. Banking Act, supra note 129, at sec. 15(1).
\item \textsuperscript{154} Blackhurst, supra note 123, at 9–10.
\end{enumerate}
requirements of section 19 of the U.K. Banking Act, the Bank of England is at present unable to mediate between a bank and its auditors. One suggestion for overcoming these alleged supervisory shortcomings is the introduction of an independent central auditing authority.

A number of reforms in auditing practice were recommended by the Institute of Chartered Accountants in a presentation to the 1985 Review Committee, including the following: (1) a formal relationship should be established between auditors and the Bank of England; (2) auditors may be required to discuss clients' affairs with the Bank of England if that supervisory authority would in turn disclose relevant information to the auditors; (3) some of the prudential and statistical returns that are made to the Bank of England should be audited; (4) the Banking Supervision Department of the Bank of England should employ on its permanent staff more professionally qualified accountants; and (5) under appropriate circumstances, the Bank of England should be able to obtain special reports from a bank's auditors.

B. REGULATIONS AND RATIOS

1. Loans to Single Borrowers

Each bank is expected to report to the Bank of England, on a quarterly basis, its ten largest loans (including guarantees) to single borrowers. While there are no statutory limits on the amount of loans that a bank may extend to any one borrower, the Bank of England has stated that such loans should not normally exceed ten percent of a bank's capital. The Bank of England has further stated that in cases where this ten percent guideline is exceeded, it will expect that correspondingly stronger capital adequacy ratios be maintained.

While rejecting formal limits, the 1985 Review Committee has recommended some changes in supervisory practices relating to loans to single borrowers. Each bank would be required to set forth in writing a policy

155. Section 19(3) of the U.K. Banking Act would permit such discussions and disclosure if the Bank of England determines that this is necessary to enable it "properly to discharge any of its functions under this Act."

156. Blackhurst, supra note 123, at 10.

157. Recommendations (1) through (5) are set forth in numbered paragraphs 12, 13, 20, 34 and 17 to 19, respectively, of the INSTITUTE OF CHARTERED ACCOUNTANTS, REVIEW OF BANKING SUPERVISION (London, Mar. 1985).

158. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 97. In the words of the Bank of England's Notice to Institutions Authorized Under the Banking Act of 1979, dated Apr. 1983, "the more an individual exposure exceeds 10 percent of the capital base, the more rigorous the Bank will be in requiring justification. If loans in excess of 10 percent of the capital base have been or are to be made, the institution will normally be requested to maintain a level of capital resources significantly higher than that which would otherwise be required."
adopted by its board of directors with respect to large exposures. The 1985 Review Committee stated that factors such as a long-standing relationship with a borrower, particular expertise in a certain type of lending and the security for the loan would be factors taken into account when considering levels of exposure up to twenty-five percent of capital. Large exposure loans extended to related borrowers were generally to be strongly discouraged. 159

2. Capital Adequacy

The Bank of England takes the position that to prescribe a precise numerical guideline for the capital needs of all institutions or even for groups of institutions would be inappropriately inflexible. However, it has devised two capital ratios which are used as a basis for assessing capital adequacy after considering the circumstances of a particular bank. The "gearing ratio" relates the capital base to all other non-capital liabilities apart from contingent liabilities. The "risk assets ratio" tests the adequacy of capital in relation to the risk of losses that may be sustained. Various classes of assets are weighted according to their supposed susceptibility to credit, investment and forced sale risk. The risk assets ratio is calculated by multiplying each balance sheet asset by its weight to produce an adjusted total of risk assets which is then related to the capital base. 160 It is significant that information concerning an individual bank's gearing ratio or risk assets ratio is not publicly disclosed. This confidential treatment reflects the view of the Bank of England that each bank should be treated on an individual basis. 161

The treatment of subordinated debt instruments as elements of a bank's secondary or external capital base has been a matter of some recent concern for the Bank of England. It has stated that an issue of perpetual debt can be structured in such a way as to give it certain characteristics of capital which make it closer to equity than subordinated debt of a given maturity. In the Bank's view, subordinated debt would not qualify as part of a bank's capital base if there are any provisions in the related loan agreement which trigger early repayment. As a further condition, the loan documentation must state that no early repayment can be made without the Bank's consent and that an interpretation of the terms and conditions applying to loan capital will be subject to English law. So-called perpetual subordinated debt satisfies the Bank of England's criteria. Such debt has no final maturity date and appears

159. 1985 Review Committee Report, supra note 126, at 11-12.
sufficiently close to equity in terms of the protection it affords depositors to rank *pari passu* with equity for capital adequacy measurement purposes.\textsuperscript{162}

The Bank of England has also focused attention on a range of off balance sheet risks to which banks may be exposed. In a policy statement released on April 3, 1985, the Bank of England expressed particular concern over the nature of obligations assumed by institutions which act as underwriters of note issuance facilities or revolving underwriting facilities (NIFs and RUFs). In the Bank's view, these obligations represent a long-term credit risk for an underwriting institution. The Bank of England therefore decided, as a provisional measure, to treat all such obligations as contingent liabilities for capital adequacy purposes and to include them in the calculation of a bank's risk asset ratio.\textsuperscript{163}

3. *Liquidity*

In developing its guidelines on liquidity, the Bank of England emphasized its intention that banks apply a prudent combination of liquidity measures appropriate to their circumstances.\textsuperscript{164} Liquidity assessment is to take account of "funding risk" which is the possibility of not having available sufficient cash to meet obligations falling due on a particular day, as well as "interest rate mismatch risk" through which a bank may suffer losses due to movements in interest rates. Liquidity measurement is based on a cash flow approach. Liabilities and assets are matched on a "maturity ladder" with the net positions in each time period being accumulated. The measure is a series of accumulating net mismatch positions in successive time periods.\textsuperscript{165} Liquidity positions of individual banks are not publicly disclosed.\textsuperscript{166}

4. *Foreign Currency Exposure*

The Bank of England distinguishes between "structural" and "dealing" positions. Dealing positions are comprised of foreign exchange exposures resulting from normal banking operations while structural positions are foreign currency exposures intended to be of a longer-term nature because they arise from fixed long-term assets and liabilities. Structural positions are excluded from foreign exchange guidelines agreed upon between the Bank of England and each bank but are included in calculating capital adequacy

\textsuperscript{162} W. P. Cooke, Some Current Concerns: Remarks at the Arab Bankers Association Conference on Banking Control and Supervision (May 7, 1985); see, generally, Bank of England, Statement on Subordinated Capital Issued by Recognized Banks and Licensed Deposit-Takers (Nov. 28, 1984).


\textsuperscript{165} Id.; *Dale, Bank Supervision*, supra note 62, at 59–60.

\textsuperscript{166} Blackhurst, supra note 123, at 9.
ratios. As general guidelines, the Bank of England would expect net open dealing positions in any one currency to be not more than ten percent of a bank's adjusted capital base and net short open dealing positions in all currencies taken together to be not more than fifteen percent of the adjusted capital base.\textsuperscript{167}

C. \textsc{Supervision of International Lending}

1. \textit{Country Risk and Provisions for Loan Losses}

The Bank of England does not set formal limits or standards for lending to particular countries.\textsuperscript{168} However, it does collect and analyze information which enables it to form an independent judgment about the risks of lending to particular countries. Country exposure of banks under its supervision is monitored by the Bank of England on a fully consolidated basis. Banks are required to submit monthly returns and more complete reports every six months detailing their loans to non-residents of the U.K. by borrower type (i.e., industrial sector, agricultural sector, etc.), country of borrower and maturity, with supplementary information to be provided for any guarantees.\textsuperscript{169} This information is used as the basis of an independent assessment by the Bank of England of a bank's internal loan portfolio. While aggregate country risk exposure information is published four times a year by the Bank of England, information on the country risk exposure of individual banks is generally not made available to the public.

There are no special requirements that banks make specific provisions against loan losses. The management of each bank is responsible for determining the appropriate level of provisions needed against loans to countries which have rescheduled, or are in the course of rescheduling, their external debt. Moreover, the existence of such provisions would be considered in


\textsuperscript{168} A study by a parliamentary committee in the United Kingdom was critical of the bank supervisory system in this area: "... in view of the evidence that banks unduly relaxed their traditional standards of prudence in their international risk lending without being brought into line by the official supervisory authorities, we are not wholly satisfied with present arrangements for bank supervision." \textit{House of Commons, Treasure and Civil Service Committee (Session 1982-1983). International Monetary Arrangements; International Lending by Banks, Vol. I} (Fourth Report) Mar. 15, 1983 at xli. [hereinafter cited as Fourth Report].

\textsuperscript{169} \textit{Bank Supervision in the Group of Ten, supra} note 140, at 97-98; Dale, \textit{Bank Supervision, supra} note 62, at 60; see also Fourth Report, supra note 168, at 153-154. Among the recommendations of the Fourth Report was that United Kingdom banks should disclose much more information about the general position of their lending to sovereign countries. The Fourth Report noted that U.K. banks were much more secretive than their counterparts in the United States.
determining capital adequacy ratios. General provisions against loan losses are treated as part of the capital base.  

Disclosure in financial statements of information about bad and doubtful loan provisions is also viewed as a matter for determination by individual banks. Only the clearing banks and a few others regularly provide such information in their financial statements.  

2. Lender of Last Resort

The Bank of England would consider acting as lender of last resort in exceptional cases of liquidity difficulties confronted by banks under its supervision. There is also a well established tradition in the United Kingdom that in a financial crisis, the Bank of England will cooperate with the major commercial banks to manage the problem. An example of such assistance was the "lifeboat" formed in 1973 to deal with the so-called "secondary banking crisis" in London. The JMB affair suggests, however, that the Bank of England might choose to intervene less in the future unless there is once again such a widespread crisis as occurred in 1973. The Bank of England only intervened in the case of JMB in view of the role JMB had in the gold market. The Bank of England is unwilling to state definitely that its lender of last resort function extends to the foreign network of the parent banks under its supervision. United Kingdom branches and subsidiaries of foreign banks are viewed as the responsibility of the parent bank's supervisory authority.  

Sections 21 to 33 of the U.K. Banking Act provide for the introduction of a mandatory deposit insurance scheme. Under the new arrangements, which became effective in February 1982, seventy-five percent of a deposi-
tor's so-called "protected deposit" is insured. A protected deposit is limited to ten thousand pounds sterling per depositor per institution. 176

3. Treatment of Branches and Subsidiaries of U.K. Banks Operating Abroad

Pursuant to general rules of consolidated returns, prudential guidelines and reporting requirements apply to branches and majority-owned subsidiaries of U.K. banks operating abroad. Commercial banks and the Bank of England agree that the lending policies of such entities are the responsibility of U.K. headquarters. 177 Of course, such branches and subsidiaries would also be subject to the requirements of the countries in which they are located.

4. Treatment of Foreign Banks in the U.K.

The general rule is that the treatment of a foreign bank operating a subsidiary in the U.K. is to be no different from that of a domestic bank. While in some cases the Bank of England might give consideration to the reputation and standing of the parent, subsidiaries of foreign banks must apply to receive deposit-taking authorization in their own right. Foreign banks operating subsidiaries in the U.K. are expected to provide assurances to the Bank of England that they acknowledge responsibility for deposits at such institutions. 178

Branches of foreign banks are treated somewhat differently. Authorization to conduct a banking business is granted to the organization as a whole rather than to the branch. Branches are not required to have separate capital and are not subject to capital adequacy requirements. 179 The Bank of England has recently stated that it intends to extend the range of statistical information collected from branches of foreign banks in order to make it more uniform with information collected from institutions incorporated in the U.K. 180 The Bank of England also intends to interview the management of such branches with respect to the conduct of branch operations more frequently than it has in the past. 181 Moreover, in the area of contingent

178. Bank Supervision in the Group of Ten, supra note 140, at 93–94. See also Bird, United Kingdom, in International Bank Accounting supra note 115, at 6.
179. Id.
180. Bank Supervision in the Group of Ten, supra note 140, at 99.
liabilities, the Bank of England has stated that it wishes to monitor branches' activities as underwriters of note issuance facilities. 182

5. Attitudes Towards International Cooperation

The following statement by a Bank of England official illustrates the ad hoc approach favored by most supervisory officials and commercial bank representatives in the U.K.:

I am not persuaded that the market mechanisms, supplemented by IMF programmes and official support, could not themselves develop and adjust, given time, ingenuity and the will to succeed. Already the bankers are showing awareness of the problems created by the bunching of maturities . . . the new relationships, which have emerged between commercial banks, borrowers and the IMF are also capable of development. 183

Among central banks, the Bank of England has played a particularly influential role in encouraging international cooperation among supervisory authorities. Attitudes towards appropriate measures to resolve the debt crisis have been strongly influenced by the work of the Cooke Committee in the development of the Basle Concordat. The emphasis of the Basle Concordat, as revised in 1983, on consolidated supervision and preventing gaps in the supervisory framework has been reflected in the public statements of the Bank of England.

IV. Bank Regulation and Supervision in the Federal Republic of Germany

A. Generally

Bank supervision in the Federal Republic of Germany reflects the dominance of the largest commercial banks. 184 The Federal Bank Supervisory Office (Bundesaufsichtsamt für das Kreditwesen) (the FBSO) has primary responsibility for the supervision of banks, but it exercises its supervisory powers in close cooperation with the Bundesbank. 185 The authority of the FBSO and the Bundesbank, the central bank, is very broad and their powers to request relevant information from banks are extensive. The Bundesbank has a relatively large supervisory staff and the FBSO, despite its location in

184. The so-called "Big Three" banks include Deutsche Bank, Dresdner Bank and Commerzbank. The focus of this analysis is on commercial banks because of their role in international lending. However, the public savings banks and the credit cooperatives constitute two other powerful banking sectors, which have also been involved in international lending activities.
185. DALE, INTERNATIONAL BANKING, supra note 105, at 134.
Berlin, rather than in the Frankfurt financial center, commands considerable respect and deference from banks subject to its supervision. The bank supervisory system is rule-based, but the prevailing assumption among commercial bankers is that rules are to be closely and carefully read and then interpreted narrowly. Until recently, the lack of consolidated reporting requirements made lending through German subsidiaries abroad an easy way to circumvent limits on loans to single borrowers as well as capital adequacy requirements.\(^{186}\)

1. The German Banking Act

The basic law is the Banking Act of July 10, 1961 (Gesetz über das Kreditwesen). It has been amended several times, with the most important changes being introduced by the so-called "Second Law," effective on May 1, 1976,\(^{187}\) and by the recently adopted German Banking Act Amendments (as so amended, the Gesetz über das Kreditwesen is referred to herein as German Banking Act).\(^{188}\) The organization, structure and functions of the Bundesbank are governed by the Bundesbank Act of 1957, as amended (the Bundesbank Act).\(^{189}\)

The Bundesbank Act defines the role of the Bundesbank with respect to the federal government. The Bundesbank’s primary responsibility is for the day-to-day management of the money supply. While the Bundesbank is obliged to support the general economic policy of the government, its

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186. Present bank supervisory arrangements reflect a number of reforms introduced after the Herstatt crisis. The Herstatt failure was due in large measure to mismanagement of foreign exchange transactions and reform efforts were subsequently directed at supervising the international sector of the German banking industry. Other reforms introduced after Herstatt included an extended deposit protection scheme and measures to encourage risk-spreading in lending. An independent Commission of Inquiry on Basic Banking Questions (the so-called "Gessler Commission") was established to look into the structure of the banking industry and consider the capital adequacy situation of German banks. More recently, measures to tighten banking regulation, have resulted from the situation in the fall of 1983 at Schroder, Munchmeyer, Hengst (SMH).

187. The authoritative text of the Gesetz über das Kreditwesen was first published in the Federal Gazette on July 10, 1961 and was significantly amended on Dec. 14, 1976; for a good general introduction to bank regulation in the Federal Republic of Germany, see H. Schneider, H-J. Hellwig and D. Kingsman, The German Banking System (1978) [hereinafter cited as Schneider, Hellwig, Kingsman]. One significant feature of the 1976 amendments to the German Banking Act was the revision of provisions limiting large loans to single borrowers (Article 13). Other important changes included increased reporting obligations of banks (Article 24), enlarged rights of intervention by supervisory authorities (Articles 35(2) and 44) and the granting of a controlling role to supervisory authorities in the case of actual and imminent bank failures (Articles 46–46c). See id. at 10.


independence is guaranteed by a provision in the Bundesbank Act which states that in case of a conflict with the Bundesbank's primary role (as indicated in the Bundesbank Act), the Bundesbank's legal duties take precedence.\textsuperscript{190}

2. \textit{The FBSO and the Bundesbank}

Although it operates with a great deal of independence, the FBSO comes within the general responsibility of the Minister of Finance and is theoretically subject to his instructions.\textsuperscript{191} The FBSO is charged with supervising banks in accordance with the provisions of the German Banking Act.\textsuperscript{192} In addition, it is the duty of the FBSO to "prevent abuses in the banking system which might endanger the security of the assets entrusted to banks, adversely affect the orderly conduct of the banking business, or substantially prejudice the economy generally."\textsuperscript{193} Regulations on such matters as capital adequacy and liquidity are issued by the FBSO after it has obtained the full agreement of the Bundesbank.\textsuperscript{194}

The German Banking Act specifies that the FBSO and the Bundesbank are to cooperate in performing their duties.\textsuperscript{195} Typically, various reports submitted by German commercial banks are collected and evaluated by the Bundesbank and then given to the FBSO, which is responsible for taking any appropriate supervisory steps.\textsuperscript{196} The Bundesbank also has monetary and economic policy functions. It is expected to cooperate with the Ministry of Finance in furnishing information and giving advice on matters affecting economic policy.\textsuperscript{197} The Bundesbank also has the duty "to regulate . . . the circulation of money and the supply of credit to the economy with the aim of safeguarding the currency, and to provide for normal banking clearance of payment transactions within the Federal Republic of Germany and with foreign countries."\textsuperscript{198}

3. \textit{Commercial Banks and the Supervisory Process}

One study has concluded that "the prevalent pattern of interaction between large German banks and their government on matters of mutual international concern has been one of quiet consensus, enhanced by official sensitivity to the banks' financial interests and the banks' responsiveness to

\begin{itemize}
\item \textsuperscript{190} Epperlein, \textit{Germany}, in \textit{INTERNATIONAL BANK ACCOUNTING}, \textit{supra} note 115, at 105.
\item \textsuperscript{191} \textsc{Schneider, Hellwig, Kingsman, supra} note 187, at 34.
\item \textsuperscript{192} German Banking Act, art. 6(1).
\item \textsuperscript{193} German Banking Act, art. 6(2).
\item \textsuperscript{194} \textsc{Dale, INTERNATIONAL BANKING, supra} note 105, at 134.
\item \textsuperscript{195} German Banking Act, art. 7.
\item \textsuperscript{196} \textsc{Schneider, Hellwig, Kingsman, supra} note 187, at 35.
\item \textsuperscript{197} \textit{Id.} at 19.
\item \textsuperscript{198} Bundesbank Act, art. 3.
\end{itemize}
government incentives and suasion.'

The FBSO, however, takes issue with this statement and emphasizes the independence of its supervisory authority. Commercial banks are consulted in the development and refinement of rules and regulations imposed by the FBSO. Commercial banks tend to work through the Federal Association of German Banks in developing uniform positions on proposed rules and reporting requirements. Commercial bank officials state that the German system of bank regulation and supervision is closer to the rule-based system of the U.S. than to the U.K. system of prudential regulation. However, they also emphasize that the FBSO and the Bundesbank do not have sufficient staff to carefully enforce all the rules. Moreover, there is a tendency for both regulators and commercial banks to interpret rules narrowly, thus encouraging a certain amount of "loophole" discovery.

4. Accounting and Disclosure Requirements

The annual reports submitted to the FBSO by external auditors must follow specific guidelines for format and content. When auditing a bank's annual accounts, such external auditors are also required to look generally into a bank's affairs to ascertain whether it has complied with all applicable financial and reporting requirements. The FBSO is authorized to conduct on-site examinations of banks, either directly or through appointed auditors. Numerous periodic reports must be submitted to the FBSO and the Bundesbank and all examiners have full access to depositor and borrower records.

Annual financial statements of German banks, including a balance sheet and a statement of income, must be made available to the public. Generally, however, reports submitted to the Bundesbank and the FBSO need not be published. Banks are required to draw up their annual balance sheet and profit and loss accounts within three months of the end of their accounting

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199. SPINDLER, supra note 42, at 181.
200. The Bundesverband deutscher Banken e.V. (Federal Association of German Banks), which is the central organization for private sector credit institutions, has its headquarters in Cologne. The FBSO often uses the Federal Association of German Banks as a means for discussion of its directives. Other associations serve other types of banking institutions. For example, Deutscher Sparkassen und Giroverband e.V. is the central organization representing regional savings bank associations. SCHNEIDER, HELLWIG, KINGSMAN, supra note 187, at 22.
201. Interview with senior official of Federal Association of German Banks, Cologne (Feb. 13, 1984); Interviews with senior officials of major commercial banks, Frankfurt (Feb. 15 and 16, 1984, and June 5, 1985), and Munich (Feb. 17, 1984) (notes on file with author).
202. German Banking Act, arts. 27 and 29. Article 29(2) states that "[i]f in the course of his audit the auditor learns of facts which might warrant the qualification or refusal of the certificate of audit, endanger the existence of the bank or gravely impair its development, or which indicate that the managers have seriously violated the law . . . he shall report this to the [FBSO] and the [Bundesbank] immediately."
203. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 43.
year. They must submit the annual accounts as drawn up and subsequently also as approved to the FBSO and the Bundesbank. An audit of a bank’s annual accounts must be carried out not later than five months after the end of the accounting year.

B. REGULATIONS AND RATIOS

1. Loans to Single Borrowers

There are detailed reporting requirements for large loans to single borrowers, whether domestic or foreign. Loans granted to any one borrower which together exceed fifteen percent of a bank’s equity capital must be reported to the Bundesbank. Large loans already reported must be reported again if they are increased by more than twenty percent of the prior reported amount. Banks are also required to report to the Bundesbank four times a year those borrowers whose indebtedness amounted to DM one million or more at any time during the three calendar months preceding the reporting date. As a matter of regular practice, the Bundesbank collects these reports on large loans and (in summary form) loans of DM one million or more and sends them with its comments to the FBSO. In addition, the FBSO may order banks to submit once a year a list of large loans subject to the reporting requirements.

There are also limits on large loans in relation to a bank’s equity capital. Pursuant to the German Banking Act Amendments no new large loan is allowed to exceed fifty percent of a bank’s capital. Until the recent changes, no loan could exceed seventy-five percent of a bank’s capital. The German Banking Act Amendments provide a transition period of five years to meet the new ceiling for existing loans which are in excess of fifty percent of

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204. German Banking Act, art. 26(1).
205. German Banking Act, art. 27(1).
206. German Banking Act, art. 13(1); a “single borrower” covers all enterprises which belong to the same group of companies or which are linked by agreements providing that the management of one enterprise is subject to the control of, or its profits are paid to, another enterprise. German Banking Act, art. 19(2).
207. German Banking Act, art. 13(1).
210. German Banking Act, art. 13(1). Under the former law, there were easy ways to avoid the limitation on large loans because there was no consolidation of large credits on the bank’s side. Thus, a bank could extend a large loan to a borrower through a subsidiary. Nissen, supra note 188, at 12–13. The German Banking Act Amendments changed this by requiring that all loans made directly or through a subsidiary or affiliate of which the parent bank controls fifty percent or more be consolidated. Amendment of the Banking Act, supra note 208, at 37.
211. German Banking Act, art. 13(4).
capital. The total of all its loans must not exceed eight times a bank's equity capital.\(^{212}\)

2. Capital Adequacy

Banks are required to maintain an "adequate equity capital" at all times.\(^{213}\) The FBSO, in agreement with the Bundesbank and after consultation with the Federal Association of German Banks, has announced certain basic principles, according to which it will normally assess whether a bank's capital and liquidity are adequate.\(^{214}\) Principle I states that the loans and equity participations of a bank (less provisions for loan losses) must not exceed eighteen times its capital.\(^{215}\) Failure to comply with this requirement creates a rebuttable presumption that the capital of the bank is insufficient and must be strengthened.\(^{216}\)

Recently, the German Banking Act Amendments tightened the implications of the eighteen times capital rule. The changes require German banks to include figures on their branches and subsidiaries in their regular reports to insure that the capital in the group as a whole will be measured against the total risk of the group.\(^{217}\) The eighteen times capital rule will be applied to a bank and its subsidiaries taken as a group. Prior to January 1, 1985 it was possible for a bank to make multiple use of its capital by establishing subsidiaries. Each subsidiary was able to extend loans of its own based upon its own capital. As one commentator noted, "taken together, the risks of the mother bank and its subsidiaries were able to exceed the eighteen fold limit, and the result was a series of 'credit pyramids.'"\(^{218}\)

Like banks in a number of other countries, German banks have been seeking new ways to raise capital. The recently developed "Genusscheine" or participation certificate is a form of equity recognized by the German

\(^{212}\) German Banking Act, art. 13(3).

\(^{213}\) German Banking Act, art. 10(1): "In the interest of performing their obligations towards their creditors, particularly in order to safeguard the assets entrusted to them, banking institutions shall maintain adequate equity capital."

\(^{214}\) See Principles Concerning the Capital and Liquidity of Banks (Grundsätze Über das Eigenkapital und die Liquidität der Kreditinstitute) of Jan. 20, 1969, as amended Jan. 16, 1980 [hereinafter cited as Capital and Liquidity Principles]. General authorization is set forth in the German Banking Act, arts. 10(1) and 11.

\(^{215}\) "Capital" is defined by the German Banking Act with respect to corporations as paid-in capital (less own shares), reserves and retained earnings (Article 10). Only reserves which are derived from after-tax income may be included in capital. "Hidden reserves" are not included and subordinated debt is not considered part of equity capital. "Hidden reserves" are created primarily through the undervaluation of specific assets and are used primarily by bank management to even out fluctuations in earnings. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 42.

\(^{216}\) Capital and Liquidity Principles, supra note 214.


\(^{218}\) Id.
Banking Act Amendments which can be counted as part of the capital base for purposes of the eighteen times capital rule provided such instruments do not exceed 25 percent of capital plus reserves. The Genusscheine gives bearers the right to a share in bank profits, but not to vote at annual shareholders' meetings.219

Note issuance facilities (NIFs), revolving underwriting facilities (RUFs) and other "off balance sheet" financing techniques have also been the subject of Bundesbank concern. The Bundesbank believes that the danger of such instruments is that an underwriting bank might have to make good its credit guarantee at precisely the time when the borrower's status was in question and no one else would lend to him.220

3. Liquidity

The German Banking Act provides that banks must at all times maintain sufficient liquidity.221 The highly complex liquidity rules attempt to keep long-term assets in a reasonable relationship to long-term financial liabilities (Principle II) and to limit the use of assets that cannot be mobilized at all times with relative speed and ease (Principle III).222 Essentially, Principle II provides that certain long-term and fixed assets must be matched by certain long-term liabilities.223 Principle III provides standards for a proper relationship between medium-term assets and various short-term and medium-term liabilities.224 If a bank does not adhere to liquidity guidelines, the FBSO may require that corrective action be taken.

4. Foreign Exchange Exposure

Principle Ia provides that a bank's net open positions in foreign currency and precious metals, irrespective of the maturity date of individual commitments, must not exceed thirty percent of capital and reserves at the close of business each day. Also on a daily basis, foreign currency positions maturing in any calendar month or within either half of the calendar year must not exceed forty percent of capital.225

221. German Banking Act, art. 11.
222. Capital and Liquidity Principles; BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 40-41; DALE, BANK SUPERVISION, supra note 62, at 31.
224. Id.
225. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 41.
C. SUPERVISION OF INTERNATIONAL LENDING

1. Country Risk and Provisions for Loan Losses

There are no specific rules relating to country risk and the Bundesbank and the FBSO do not attempt to provide a comprehensive or independent view of the financial prospects of individual countries. German commercial banks, like other German financial institutions, are responsible for independently monitoring and evaluating country risk. Formerly, pursuant to a so-called "gentlemen's agreement," and, subsequent to July 1, 1986, in accordance with a legal requirement imposed by the German Banking Act Amendments, German banks submit to the FBSO and the Bundesbank on a periodic basis comprehensive consolidated information on country risk. The purpose is to monitor more effectively the activities of foreign subsidiaries, particularly Luxembourg subsidiaries through which a substantial portion of international loans are booked. Moreover, pursuant to 1980 guidelines issued by the FBSO, audit reports must contain detailed information on country risk.

German commercial banks generally have well-developed country risk analysis procedures and departments. In addition, banks have gradually been increasing their provisions for loan losses. Moreover, a somewhat greater reliance on government-backed export financing as a percentage of total foreign lending is viewed as a means of reducing country risk exposure. German commercial banks readily acknowledge the central and growing role of such "Hermes" covered credits in their total lending picture.

"Hidden reserves" are permitted under German law. Such hidden reserves enable German banks to report steady profits and can be used to smooth out any fluctuations in earnings. Hidden reserves are built up through the use of various accounting techniques: (a) the consistent application of codified or generally accepted accounting principles, such as the use of historic cost accounting rules in a period of inflation; (b) the adoption of valuation options, such as writing down investments to the lower of cost or

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226. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 44.
228. In the past, banks have had some flexibility in deciding which loans require provisions, but the Bundesbank has begun to take a more conservative position. See Hogan, A Common Approach is Slow to Emerge, Fin. Times, May 21, 1984, § III (World Banking Survey), at 4.
market value; and (c) the creation of a general provision for bad debts in excess of what is reasonably required.\textsuperscript{230}

2. Lender of Last Resort

The Bundesbank is the primary source of liquidity for German commercial banks. Policies as to a lender of last resort have been quite heavily influenced by the Herstatt crisis, as a result of which several banks had to be given liquidity assistance on an \textit{ad hoc} basis. Shortly thereafter, the Liquidity Consortium Bank (the Liko-Bank) was established. The Liko-Bank's sole function is to give assistance to banks that have run into temporary liquidity difficulties but are otherwise solvent institutions. Some thirty percent of the Liko-Bank's equity capital is subscribed by the Bundesbank. In addition, the Liko-Bank has been granted a special rediscount ceiling by the Bundesbank. In practice, the relatively small capital base of the Liko-Bank limits its assistance to smaller banks and its facilities have been used infrequently.\textsuperscript{231} The Bundesbank is reluctant for prudential reasons to state clearly its willingness to serve as lender of last resort under various circumstances. The Bundesbank disclaims such responsibility in particular cases where commercial banks confront true solvency problems.\textsuperscript{232} The Bundesbank emphasizes that it expects German commercial banks to maintain reserves that would render central bank assistance unnecessary except in the most generalized and widespread financial crisis.

3. Treatment of Branches and Subsidiaries of German Banks Operating Abroad

Prior to the recent adoption of the German Banking Act Amendments, there were no domestic restrictions on German banks that wished to establish overseas branches or purchase foreign subsidiary banks. Traditionally, foreign subsidiaries, in particular, were not effectively integrated into the domestic bank supervisory system.\textsuperscript{233} Only business conducted through a bank's branches abroad needed to be reported to the FBSO in Berlin. One result was that a major problem for bank regulators in the Federal Republic of Germany was the large number of international loans made through foreign subsidiaries, especially in Luxembourg, that escaped effective regulation.\textsuperscript{234} Recently adopted rules on consolidation will end the practice of circumventing domestic regulation by making loans through subsidiaries.

\textsuperscript{230} Epperlein, \textit{Germany}, in \textit{International Bank Accounting}, \textit{supra} note 178, at 111.

\textsuperscript{231} \textit{Bank Supervision in the Group of Ten}, \textit{supra} note 140, at 45.

\textsuperscript{232} Interview with senior officials of the Bundesbank, Frankfurt (Feb. 14, 1984, and June 5, 1985).

\textsuperscript{233} \textit{Bank Supervision in the Group of Ten}, \textit{supra} note 140, at 40.

\textsuperscript{234} Nissen, \textit{supra} note 188, at 12.
Pursuant to rules established in accordance with a 1983 European Community Council Directive, commercial banks are now required to file with the supervisory authorities a consolidated balance sheet covering all subsidiaries in which they have a stake of fifty percent or more. The new rules also provide for mandatory cooperation between West German bank regulatory authorities and those in other EEC member states. This is the logical culmination of the "gentlemen's agreement" of 1978, pursuant to which German banks began voluntarily to submit audit reports covering their Luxembourg subsidiaries.

A recent Bundesbank report has provided some additional details on the operation of Luxembourg subsidiaries prior to the adoption of consolidation requirements. In 1979, all of the Luxembourg subsidiaries recorded after-tax profits, but by 1984 only half of them were profitable. In 1984, West German banks controlled twenty-six subsidiaries in Luxembourg. According to the Bundesbank report, the Luxembourg subsidiaries made far more credit available to problem debtor countries than did the parent German banks.

4. Treatment of Foreign Banks in the Federal Republic of Germany

Individual branches of foreign banks must be licensed by the FBSO. Foreign bank branches are subject to the same conditions and limitations on their activities as are domestic banks. There are no special rules for banks owned by foreigners. The German Banking Act Amendments introduced a reciprocity requirement for the establishment of branches in the Federal Republic of Germany. A bank license could be denied if there is no reciprocal freedom in the country of origin for a German bank to establish branches.

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235. See discussion in Nissen, supra note 188, at 12. The impact of the amendments on German banks will be substantial and they are to be phased in gradually. The consolidated equity ratios do not have to be met in full until Jan. 1, 1990. The German Banking Act Amendments had an effective date of Jan. 1, 1985, but the provisions on consolidated reporting were to become effective on July 1, 1985 and those relating to loans of DM one million or more were to become effective on July 1, 1986. The consolidation rules are a response to the SMH crisis as well as to the need to conform to EEC guidelines on consolidation that became effective in mid-1985. Directive of the Council of the European Communities, June 13, 1983, Official Gazette E10, No. L193, at 18.

236. The German Banking Act Amendments specifically authorize German bank regulatory authorities to transmit all relevant data on banks under their jurisdiction to the regulatory authorities of other countries. Nissen, supra note 188, at 15.


238. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 39.

239. Nissen, supra note 188, at 15.
5. **Attitudes Towards International Cooperation**

The Bundesbank has publicly stated its opposition to a greater role for international agencies, in general, and the IMF, in particular, as a method of resolving the debt crisis. In its annual report for 1982, for example, the Bundesbank stated that it opposed any steps which would lead the IMF in the direction of taking over or otherwise providing a guarantee of LDC debt. In the Bundesbank’s view, the IMF must not allow itself “to be seduced either by creditor countries or by commercial banks, into taking over part of the outstanding debt”\(^\text{240}\) Similarly, Herr Gerhard Stoltenberg, Finance Minister, has stated that the World Bank should continue to fulfill its traditional role of lending for specific projects in developing countries and should not shift its emphasis to more general structural adjustment programs.\(^\text{241}\)

Both the Bundesbank and German commercial banks have supported greater international cooperation utilizing the present structure of BIS, IMF, World Bank and central bank relations. One reason to prefer the status quo is probably to be found in the relatively small West German banking share in credits extended to Latin American countries.\(^\text{242}\) This may also explain the West German decision (together with a similar Swiss one) to refuse to take part in the $450 million Argentine debt rescue.\(^\text{243}\) As Dr. Wilfried Guth (now retired), spokesman for the Board of Directors of Deutsche Bank, has noted:

One of the most important lessons of this crisis period is the confirmation of the crucial importance of the [IMF and World Bank]. Rather than pondering over the need for new institutions, governments and parliaments, we ought to do everything to keep these well-established and highly efficient institutions intact, and to assure the adequacy of their capital base. . . .\(^\text{244}\)

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\(^{242}\) The West German share of all commercial bank credits extended in 1984 was as follows: 6.4 percent to Brazil, 4.8 percent to Mexico and 9.3 percent to Argentina. However, West German banks have put up 19.5 percent of Western credits to the Soviet Union, 25.6 percent to Poland and 16.5 percent to Yugoslavia. The West German share is also particularly high in the case of Turkey (33.1 percent) and Nigeria (18.2 percent). Carr, *West German Banks Detail Overseas Loans*, Fin. Times, May 21, 1985, at 3.


\(^{244}\) Guth, *Challenges to the International Financial System*, in 51 *Atlantic Papers* 31–32 (September 1983); *see also* Guth, *International Debt Crisis: The Next Phase*, 133 *The Banker* 25 (1983); and *see* Address by H. Linss (Bayerische Landesbank Girozentrale), Sovereign Risk and Lending—Time for Reassessment? Bahrain (Dec. 11–12, 1983). Dr. Linss suggests greater cooperation between existing international organizations, as well as co-financing with commercial banks by the World Bank. He adds, “I believe that the process of normalization has already begun.”
V. Bank Regulation and Supervision in Japan

A. Generally

1. The Japanese Banking Law

The Banking Law of 1927, as amended in 1981 (the Japanese Banking Law), outlines the basic regulatory framework relating to the conduct of banking business in Japan. In addition to stating the statutory goals of facilitating “orderly credit” and “sound and appropriate management of banking business,” the Japanese Banking Law sets forth particular laws for accounting practices of banks, supervision by the Ministry of Finance, the merger or acquisition of banks, the conduct of a banking business by the branches of foreign banks, and certain other matters. The prototype of Japan’s bank supervisory system is often said to be the United Kingdom system, with its emphasis on prudence, tradition and consultation rather than statutes and rules, and a place for the Bank of Japan at the apex of the financial structure similar to that of the Bank of England. However, the recent amendments were intended in part to shift the emphasis away from administrative guidance towards a more formal regulatory scheme. During the American occupation after World War II, numerous reforms in the banking system were introduced and the current supervisory system also reflects this influence.

2. The Bank of Japan and the Ministry of Finance

Article 1 of the Bank of Japan Law states that the Bank of Japan has responsibility for “the regulation of the currency, the control and facilitation of credit and finance, and the maintenance and fostering of the credit system.” Pursuant to this statutory authority, the Bank of Japan has


246. Articles 17 through 23 of the Japanese Banking Law deal with accounting practices; articles 24 through 29, bank supervision; articles 30 through 36, merger and transfer or acquisition of operation or business; and articles 47 through 52, branches of foreign banks.

247. FEDERATION OF BANKERS ASSOCIATIONS OF JAPAN, BANKING SYSTEM IN JAPAN (1982) at 1 [hereinafter referred to as the FEDERATION REPORT].

248. Following the American pattern, for example, banks were forbidden to engage in underwriting securities except public bonds and debentures. Japanese Banking Law, art. 10. See also Japanese Securities and Exchange Law, art. 65.

249. Bank of Japan Law, art. 13, para. 2, provides for the establishment of a Policy Board in the Bank of Japan. The Policy Board has the duty “to formulate, direct and/or supervise currency regulation, credit control and other basic monetary policies pertaining to: (1) the
directed the behavior of Japanese banks on such central matters as interest rates and lending volume. Through its "window guidance" of banks' requests for funds at its discount window, the Bank of Japan exercises a control that extends to all aspects of commercial credit and the money supply.  

The true basis of the supervisory authority of the Bank of Japan is its contractual agreements with client banks. Pursuant to these individual agreements, the Bank of Japan normally conducts biennial examinations of Japanese commercial banks on a pre-announced basis.

Real supervisory power in the Japanese banking system, however, resides in the Ministry of Finance. In contrast to the Bank of Japan's largely contractual authority, the Ministry of Finance is granted broad supervisory authority under the Japanese Banking Law. One observer has stated that the responsibilities of the Ministry of Finance "incorporate, in U.S. terms, those of the Treasury, Internal Revenue Service, SEC, state banking commissions and policy-making responsibilities of the FRB." The Ministry of Finance may, among other powers, require (if it is deemed "necessary to insure the sound and appropriate management of bank business") a bank to submit a report on its business activities or financial position. The Ministry of Finance interprets this power broadly as a basis for general or specific requests for information from banks under its supervision at any time.

Another powerful supervisory tool of the Ministry of Finance is its ability to exercise supervision through so-called "administrative guidance" or guidelines, through which the Ministry of Finance encourages and guides banks to cooperate voluntarily on matters under its jurisdiction. Essentially, these are legally nonbinding directives which may be issued either formally

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251. The Bank of Japan emphasizes that such examinations are carried out quite independently of the Ministry of Finance. The Bank of Japan does not inform the Ministry of Finance about its findings with respect to particular banks. Interview with senior officials, Bank of Japan, Tokyo (July 19, 1984) (notes on file with author).


255. Interview with senior officials, Ministry of Finance, Tokyo (July 19, 1984) (notes on file with author).
or informally. In addition, the Ministry of Finance retains broad authority to issue legally binding banking rules.

3. Commercial Banks and the Supervisory Process

One distinguishing feature of the Japanese banking system is its segmentation into “all-banks,” including “city banks,” regional banks and trust banks, long-term credit banks and foreign exchange banks. Each banking type has a specific place in the overall banking system. City banks, which play a major role in international lending, are generally based in large cities and operate nationwide through widely distributed branch offices. Long-term credit banks were created in 1952 to assist the then underdeveloped Japanese capital market by issuing bank debentures. They have subsequently become important sources of long-term funds for foreign borrowers. The Bank of Tokyo, a specialized foreign exchange bank, is principally engaged in foreign exchange transactions and foreign trade financing.

A second distinguishing feature of the Japanese banking system has been the close relationship between major commercial banks and affiliated industrial enterprises. Industrial conglomerates (zaibatsu) dominated Japanese business in the years prior to World War II. While some informal groupings (keiretsu) have replaced zaibatsu, the traditional close relationship between the major commercial banks and affiliated industrial and financial entities has remained.

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256. Bank Supervision in the Group of Ten, supra note 140, at 57. See also Spindler, supra note 42, at 103. Spindler states that “if one takes into account the impact of administrative guidance, Japanese banks rank among the most intensely supervised in the non-Communist developed world.” Id.

257. Currently, there are thirteen city banks: The Dai Ichi Kangyo Bank, the Fuji Bank, the Sumitomo Bank, the Sanwa Bank, the Mitsubishi Bank, the Tokai Bank, the Taiyo Kobe Bank, the Mitsui Bank, the Daiwa Bank, the Kyowa Bank, the Saitoma Bank, the Hokkaido Takushoku Bank and the Bank of Tokyo (a specialized foreign exchange bank, but also traditionally numbered among the city banks).

258. The division of the financial marketplace into particular “spheres of interest” has been a source of controversy in U.S.-Japanese economic relations. It was discussed at length in a recent joint Japan-United States report on the nature of the Japanese business system and what steps might be taken to bring Japanese actions more into line with financial practices elsewhere.

259. At present, there are three long-term credit banks: the Industrial Bank of Japan, the Long-Term Credit Bank of Japan and the Nippon Credit Bank.

260. Interview with senior officials of a major long-term credit bank, Tokyo (July 24, 1984) (notes on file with author).

261. Under the Foreign Exchange and Foreign Trade Control Law, all foreign exchange business must be conducted by authorized foreign exchange banks. There are currently 186 authorized foreign exchange banks in Japan, including a specialized foreign exchange bank, the Bank of Tokyo, and the twelve other city banks. The Foreign Exchange Bank Law authorizes a specialized foreign exchange bank to issue debentures up to ten times the combined total of its capital and reserves (“own capital”). Foreign Exchange Bank Law, art. 9, para. 2.

262. Most of the major city banks, with the notable exception of Fuji Bank, are members of such keiretsu.
A third factor of great significance is the traditional reliance on "administrative guidance" rather than statutes and formal regulations in the relationship between commercial banks and their supervisors. The influence of supervisors on bank conduct is very great, and in the words of one observer: "It is no exaggeration to say that little of consequence happens in Japan without formal or informal approval from the Ministry of Finance and sometimes the Bank of Japan." There has traditionally been a great reluctance on the part of the Bank of Japan and Ministry of Finance to relax control and their tendency has been to err on the side of caution.

4. Accounting and Disclosure Rules

One result of the new Japanese Banking Law has been the formal adoption of an annual rather than semiannual "business term" or basic accounting period. Pursuant to the so-called "Bank Accounting Standards" developed by the Ministry of Finance, banks are to account for their business practices in terms of "fairness, clarity, and continuity." Like other businesses in Japan, banks are subject to the auditing requirements of the Japanese Commercial Code. A minimum of two auditors and one certified public accountant must be appointed by each bank, with the auditors being primarily responsible to bank management and the certified public accountant to a bank's shareholders. Operating pursuant to a contract with a given bank, auditors are authorized to receive any information deemed necessary to investigate the financial condition of a bank and are required by law to report illegal actions to the bank's board of directors. Shareholders regularly appoint a certified public accountant who is responsible for the accuracy of published financial statements.

The contents of financial statements are governed by the Japanese Banking Law. Article 19 specifies that for each business year, a bank must prepare and submit to the Ministry of Finance interim and final business

263. See Spindler, supra note 42, at 107: "Japanese bank supervision is based fundamentally on operational understandings, not written rules." See also Dale, International Banking, supra note 105, at 113: "The relatively small number of commercial banks has enabled the authorities to adopt a highly informal approach to bank supervision based on administrative guidance."

266. Japanese Banking Law, art. 17, provides that "a bank's business term shall be from April 1 to March 31 of the next year."
267. Federation Report at 107; Ichikawa, Japan in International Bank Accounting supra note 115, at 259. The Bank Accounting Standards, which are included in the Basic Circular for Ordinary Banks originally issued on Apr. 1, 1982 (Kuragin No. 901), supplement the accounting standards for banks set forth in the Banking Laws.
268. Bank Supervision in the Group of Ten, supra note 140, at 62.
reports describing its business activities and financial position. More limited information is required to be submitted to the public. Article 20 of the Japanese Banking Law requires each bank to compile a balance sheet and a statement of profits and losses for each business year and make them public within a three-month period after the end of each business year. In addition, a kind of abbreviated business report must be prepared for public perusal at the main office of each bank.

B. REGULATIONS AND RATIOS

1. Loans to Single Borrowers

Prior to the effectiveness of the amended Japanese Banking Law on April 1, 1982, controls over large loans by banks to single borrowers were based on administrative guidance deriving from general supervisory powers granted to the Ministry of Finance. Article 13 of the Japanese Banking Law now states that a bank may not grant credit facilities to a single borrower (and its affiliates) in excess of an amount which is the product of the total of the bank's capital and reserves (own capital) and a percentage which is determined by order of the Ministry of Finance.

The Ministry of Finance limits on loans to single borrowers now in effect are twenty percent of own capital in the case of ordinary commercial banks, thirty percent for long-term credit banks and forty percent for specialized foreign exchange banks. A less precise kind of control over loans to single borrowers is exercised by the Bank of Japan. It may use its “window guidance” in operating its discount window to either encourage or discourage banks which use its facilities to fund international lending.

2. Capital Adequacy

Capital is defined as equity capital plus reserves for the purposes of capital

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269. Japanese Banking Law, art. 19(1). In the matter of business reports, the Ministry of Finance has been given wide discretion, Japanese Banking Law, art. 19(2). Japanese Banking Law, art. 22, provides that matters to be contained in the business report are to be designated by ordinance of the Ministry of Finance.

270. Japanese Banking Law, art. 21, states, however, that “a bank shall be under no obligation to furnish information on such matters as will undermine financial order, disadvantage secrets of depositors and other customers, hamper banking operations unduly, or incur an excessive burden of expenses for compilation.” See FEDERATION REPORT, supra note 247, at 22.

271. Japanese Banking Law, art. 13(1).

272. FEDERATION REPORT, supra note 247, at 103; BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 60. Effective Mar. 31, 1987, the twenty percent limit will also apply to branches of foreign banks. The limitation will be based on the bank's total capital and reserves rather than that of the individual branch or branches. As applied to Japanese banks, both administrative guidance and specific rules are generally based on worldwide consolidated figures.

273. SPINDLER, supra note 42, at 104.
In lieu of specific rules, the Ministry of Finance has provided banks with administrative guidance that includes specific ratios. For example, a bank's own capital should be greater than ten percent of total deposits. Fixed assets for business use are to be less than fifty percent of net worth, and, if possible, below forty percent. The average ratio of loans to deposits is to be below eighty percent. Finally, dividends are generally limited to fifteen percent of equity capital and forty percent of after-tax net income. Such limitations on the payment of dividends are seen as a means of influencing the capital accumulation of banks.

The Ministry of Finance recently introduced a series of new guidelines on overseas operations of Japanese banks, including a risk-asset ratio system for their off balance sheet transactions. The introduction of a risk-asset ratio requirement is being considered for 1986. However, Japanese regulators must decide on detailed weightings of off balance sheet items before the risk-asset ratio system is adopted.

3. Liquidity

The Ministry of Finance has been encouraging banks to raise the ratio of the average balance of current assets to total deposits to thirty percent or more. The annual average of liquid assets (including cash, short-term inter-bank deposits and readily marketable securities) is to be at least thirty percent of the annual average of total deposits. Some special guidance has been given with respect to banks' Eurocurrency operations. As of February 1983, 45 percent of term lending for one year or more was to be funded by term deposits or other debt of over one year's maturity. The proportion of borrowings with matching terms was set at fifteen percent for loans of longer than three years. These guidelines have been applied to foreign branches but not subsidiaries of Japanese banks. A factor which reduces mismatching in the banking system as a whole is the concentration of domestic long-term lending in long-term credit banks and trust banks.

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274. DALE, INTERNATIONAL BANKING, supra note 105, at 113.
275. FEDERATION REPORT, supra note 247, at 106; BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 59.
276. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 59.
277. Id. This ratio has apparently been a source of some difficulty for Japanese banks. At many times over the past twenty years, the ratio of loans to deposits has been consistently above the standard. See also FEDERATION REPORT, supra note 247, at 106.
278. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 60.
279. DALE, INTERNATIONAL BANKING, supra note 105, at 113.
281. BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 59. DALE, BANK SUPERVISION, supra note 62, at 42; FEDERATION REPORT, supra note 247, at 106.
282. DALE, INTERNATIONAL BANKING, supra note 105, at 114.
283. Id.
4. Foreign Exchange Exposure

The foreign currency operations of banks authorized to engage in foreign exchange transactions are monitored through on-site unannounced examinations by the Ministry of Finance. In general terms, guidelines applicable on a daily basis are set by the Ministry of Finance for each bank’s net spot position in foreign exchange as well as for spot plus forward positions. Moreover, banks are required to report their positions monthly with a breakdown into a number of major currencies. There are further guidelines with respect to the degree of mismatching that is permitted. While strict limits are not applied, banks generally keep their foreign exchange exposure below ten percent of capital.

C. Supervision of International Lending

1. Country Risk and Provisions for Loans Losses

Each Japanese bank is responsible for developing its own country risk evaluation system. The Ministry of Finance and the Bank of Japan view the development of such a system as an integral part of a bank’s conduct of business and as an element which may be “guided” but not created by supervisory authorities. The Japan Center for International Finance was established in March 1983 for the purpose of providing information on country risk to sponsoring banks.

While it disclaims any responsibility for developing country risk evaluation systems, the Ministry of Finance did issue administrative guidance in early 1983 concerning the management of international activities. Japanese banks were required by the terms of the directive to report in detail their total exposure to major debtor countries on a consolidated semiannual basis. Japanese banks were further advised to limit the size of their foreign currency assets to fifteen times capital and to keep their interbank deposit

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284. Bank Supervision in the Group of Ten, supra note 140, at 61.
286. Bank Supervision in the Group of Ten, supra note 140, at 61.
288. One bank outlined its system as including the following: “Research and analysis of the conditions of each country; evaluation; establishment of lending policy and credit ceilings for each country; control of credit balances extended.” The system consists of the twice-yearly evaluation of information about 106 countries, to each of which sovereign lending was expected to exceed U.S. five million dollars annually. The system provides for the grading of countries and the setting of absolute credit ceilings. Each country is given a grade of one to twenty-five by plotting its GDP size against its rank (seventeen quantitative and nine qualitative factors). One of twenty-five absolute credit ceilings is then assigned, corresponding to the determined grade. Written statement and interview with senior officials of a major city bank, Tokyo, Japan (July 26, 1984) (notes on file with author).
289. The reasoning is that the Bank of Japan or the Ministry of Finance, as the case may be, would have to assume responsibility for the failure of such risk evaluation systems if their content was determined by supervisory authorities.
claims as well as call loans in foreign currencies to within sixty percent of their total foreign currency assets. Finally, Japanese banks were to set up special provisions against loans to specified "financially troubled" countries. While total loan loss reserves were not to exceed five percent of a bank's loan portfolio, a figure as high as fifty percent may be applicable to loans for individual countries.

The Ministry of Finance has further developed specific guidelines for international lending. Such matters as the percentage of new international loans relative to all syndicated loans, the percentage of such lending to be directed to developing countries, the maximum participation of Japanese banks in individual syndications and the size of spreads have been the subject of directives by the Ministry of Finance.

In January of 1984, the Ministry of Finance stated that Japanese banks would be allowed to make a tax-free provision for rescheduled loans and new money advanced to problem countries after April 1, 1984. The maximum tax-free provision was to be one percent of a bank's exposure to a particular country. The new tax position was said by one observer to be a political move to encourage Japanese banks to continue lending at a time when new bank loans were essential to save major Latin American debtors. "Hidden reserves" may no longer be used by Japanese banks in determining their provisions for loan losses. Formerly, the Ministry of Finance restricted the overstatement of profits but permitted banks to maintain more reserves than were allowed for ordinary corporations.

2. Lender of Last Report

The Bank of Japan essentially views its lender of last resort function as extending to liquidity matters only. However, there is a statutory basis for intervention in the event of either solvency or liquidity crisis of a generalized nature. Article 25 of the Bank of Japan Law permits the Bank of Japan to...

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290. Interview with senior officials of Ministry of Finance (July 19, 1984) (notes on file with author); BANK SUPERVISION IN THE GROUP OF TEN, supra note 140, at 60-61. The so-called "provisions for specific overseas loans" were to be included in the figure of loan loss provisions in the income statement and in the total of loan loss reserves on the balance sheet for a description of requirements prior to the issuance of the 1983 directive on country risk exposure, see Pecchioli, supra note 285, at 90; DALE, BANK SUPERVISION, supra note 62, at 43; and DALE, INTERNATIONAL BANKING, supra note 105, at 114.

291. DALE, INTERNATIONAL BANKING, supra note 105, at 115.


293. Ichikawa, Japan, in INTERNATIONAL BANK ACCOUNTING, supra note 115, at 261. The Ministry of Finance in a Sept. 1967 administrative circular provided that income and expenses must be recorded accurately on an accrual basis. Depreciation and provisions for loan losses were to be accounted for uniformly by all banks and not accounted for by the bank's own judgment.

294. The Bank of Japan also expects that its lender of last resort function would be exercised only in yen. Of course, if a Japanese bank experiences liquidity problems in a foreign currency, the Bank of Japan could make yen available for conversion into a foreign currency.

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make loans to Japanese banks on special terms if they are "necessary for the maintenance and fostering of the credit system." 295

3. Treatment of Branches and Subsidiaries of Japanese Banks Operating Abroad

Supervision of Japanese banks, whether exercised by the Bank of Japan or Ministry of Finance, is based on consolidated accounts. 296 All Japanese commercial banks conduct foreign lending activities of significance from headquarters in Japan. In the past, however, there was some possibility that lending activities of locally incorporated subsidiaries in which Japanese banks had a substantial but not a majority interest could escape control by headquarters. However, the 1981 amendments to the Japanese Banking Law provided that approval of the Ministry of Finance would be needed if a bank wished to acquire a percentage above a specified threshold of shares of a company that would engage in banking activities in a foreign country. 297 More recently, the desirability of supervising banks on a consolidated basis has been accepted by Japanese supervisory authorities. The Banking Bureau's prudential bank examinations, for example, would include foreign branches of Japanese banks.

4. Treatment of Foreign Banks Operating in Japan

In theory, the Japanese Banking Law is to apply to foreign banks in the same manner that it applies to Japanese banks. However, as stated in the Federation Report, "[i]n actual application of the law, the principle of reciprocity with the country from which the foreign bank comes will be given importance more than anything else." 298 Until recently, there were no subsidiaries of foreign banks in Japan. In order for a foreign bank to operate a subsidiary, approval was required from appropriate government authorities under the Anti-Monopoly Law, the Banking Law and the Foreign Exchange and Foreign Trade Control Law. Obtaining approval under all of these laws was said to be almost impossible in practice. 299 In 1985, foreign banks were allowed to open branch offices in Japan for their securities

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295. Bank Supervision in the Group of Ten, supra note 140, at 63; Bank of Japan Law, art. 25, states that: "The Bank of Japan may, with the permission of the competent Minister, undertake such businesses as are necessary for the fostering of the credit system."

296. Wholly-owned and majority-owned subsidiaries are included in such consolidated accounts and some progress has been made in extending the scope of consolidation to foreign affiliates. The requirement that banks prepare financial statements on a consolidated basis dates back to Oct. 30, 1976, when Ministerial Ordinance No. 30 was promulgated. Beginning Apr. 1, 1977, all companies whose stock was listed on the stock exchange were required to prepare consolidated financial statements.

297. Japanese Banking Law, art. 9(1).


299. Ichikawa, Japan, in International Bank Accounting, supra note 115, at 258.
subsidiaries, as long as the capital stake of the parent bank and its affiliates remained under fifty percent.  

Approximately seventy-five branches of foreign banks have been licensed by the Ministry of Finance under Article 47 of the Banking Law to conduct a banking business. While reciprocity considerations appear to be most important in determining whether or not to grant a license to a branch, certain other factors are also considered by the Ministry of Finance: (a) financial strength, credit status, and size of the bank; (b) the length of time for which the foreign bank has had a representative office in Japan, and (c) the impact of the proposed branch on Japanese financial institutions. Article 48 of the Japanese Banking Law provides broad discretion in the exercise of the supervisory role of the Ministry of Finance. Such reports on the activities or position of a branch of a foreign bank as the Ministry of Finance deems necessary for the sound and appropriate management of the foreign bank's branch may be required.

While providing ample room for comprehensive supervision by the Ministry of Finance, the current provisions of the Japanese Banking Law represent a liberalization of past provisions. Differential operating regulations, including restraints on soliciting local deposits and authorization requirements applicable to making yen-dominated loans to nonresidents, have been removed.

5. Attitudes Towards International Cooperation

The global debt crisis has led to a sense that greater international commitments will be required in the future at both the commercial bank and supervisory levels. One token of this attitude is that Japan is now the second largest contributor to the World Bank. Japanese commercial banks and bank supervisory authorities express a willingness to work towards greater cooperation in resolving the LDC debt crisis. However, it is commonly acknowledged that progress must first be made in the liberalization of Japanese domestic financial markets.

Editor's note: Part II, to be published in the next issue of THE INTERNATIONAL LAWYER (volume 20, number 1) will include analyses of the regulation and supervision of bank lending in the creditor countries of France, Belgium, The Netherlands and Switzerland. Suggestions for reform will also be offered.

301. Japanese Banking Law, art. 48(2).