

**INTERNATIONAL
FINANCE**

**TRANSACTIONS, POLICY,
AND REGULATION**

SIXTH EDITION

HAL S. SCOTT

PHILIP A. WELLONS

UNIVERSITY CASEBOOK SERIES

INTERNATIONAL FINANCE

TRANSACTIONS, POLICY, AND
REGULATION

SIXTH EDITION

By

HAL S. SCOTT

Nomura Professor of International Financial Systems
Harvard Law School

PHILIP A. WELLONS

Deputy Director
Program on International Financial Systems
Harvard Law School

NEW YORK, NEW YORK

FOUNDATION PRESS

1999

COPYRIGHT © 1995, 1996, 1997, 1998 By FOUNDATION PRESS
COPYRIGHT © 1999 By FOUNDATION PRESS

11 Penn Plaza, Tenth Floor
New York, N.Y. 10001
Phone (212) 760-8700
Fax (212) 760-8705

All rights reserved

Printed in the United States of America

ISBN 1-56662-800-8



TEXT IS PRINTED ON 10% POST
CONSUMER RECYCLED PAPER



UNIVERSITY CASEBOOK SERIES

EDITORIAL BOARD

ROBERT C. CLARK

DIRECTING EDITOR

Dean & Royall Professor of Law
Harvard University

DANIEL A. FARBER

Henry J. Fletcher Professor of Law
University of Minnesota

OWEN M. FISS

Sterling Professor of Law
Yale University

GERALD GUNTHER

William Nelson Cromwell Professor of Law, Emeritus
Stanford University

THOMAS H. JACKSON

President
University of Rochester

HERMA HILL KAY

Dean & Barbara Nachtrieb Armstrong Professor of Law
University of California, Berkeley

DAVID W. LEEBRON

Dean & Lucy G. Moses Professor of Law
Columbia University

SAUL LEVMORE

William B. Graham Professor of Law
University of Chicago

ROBERT L. RABIN

A. Calder Mackay Professor of Law
Stanford University

CAROL M. ROSE

Gordon Bradford Tweedy Professor of Law & Organization
Yale University

DAVID L. SHAPIRO

William Nelson Cromwell Professor of Law
Harvard University

P R E F A C E

This is the sixth edition of our textbook on international finance. Six major changes in the area have occurred since the fifth edition was published a year ago. The International Accounting Standards Committee completed its basic work on international accounting standards, covered in Chapter 2. The Basle Bank Supervisors Committee issued new proposals to revise the 1988 Basle Accord's approach to credit risk, covered in Chapter 4. The Euro was successfully launched in 11 countries on January 1, 1999. This is primarily dealt with in Chapter 7, but the effect of this adoption on financial markets is discussed throughout the book. Japan's financial system continues to struggle, and new measures under the banner of Big Bang have been adopted to restore it to health, covered in a thoroughly revised Chapter 8. The Long-Term Capital Management hedge fund collapse and rescue is dealt with in Chapter 18. Finally, the new "financial architecture" spawned by the 1997 Asian crisis is covered in Chapter 21.

The book is organized into three parts. Part One deals with the international aspects of major domestic markets, Part Two with instruments and offshore markets, and Part Three with emerging markets. There are also four infrastructure chapters woven throughout the three parts covering capital, foreign exchange, the payment system and clearance and settlement. We have updated the data throughout the book wherever possible, and once again thoroughly reedited existing material to increase the book's readability.

While our approach is rooted in government policy and regulation, the book introduces the student to basic financial concepts and transactions. Exchange rate regimes, for example, are necessary background for an understanding of the European Monetary Union. And a student of futures, options and swaps must understand the basic characteristics and functions of these instruments. Only the most basic financial theory is presented. We believe our approach is original and complements existing texts written for finance or economics courses.

We gratefully acknowledge the dedicated assistance of our secretaries Stephanie Bright and Debra Mattina.

Hal S. Scott
Philip A. Wellons

Cambridge, Massachusetts
June 1999

ACKNOWLEDGMENTS

We gratefully acknowledge permission to publish excerpts from the following material.

M. Carter, "The Impact of Pension Investments on the World's Financial Market Structure," a paper given at Harvard Law School, November 15, 1993

Reprinted with permission from M. Carter and Y. Zhou.

P. Cooke, excerpts from Bank Capital Adequacy, Price Waterhouse, London (July 1991)

Reprinted with kind permission from Price Waterhouse.

G. Dufey and T. Chung, "International Financial Markets: A Survey," in R. L. Kuhn, ed., *International Finance and Investing* (1990)

Reprinted with permission from G. Dufey and T. Chung; reprinted with permission of Richard D. Irwin, all rights reserved.

Euroclear, Cross-Border Clearance, Settlement and Custody: Beyond the G30 Recommendations (June 1996)

Reprinted with permission from Morgan Guaranty Trust Company of New York, as operator of the Euroclear System.

D. Gail, J. Norton and M. O'Neal, "The Foreign Bank Supervision Act of 1991: Expanding the Umbrella of Supervisory Regulation" 26 *International Lawyer* 993 (1992)

Reprinted by permission; Copyright © 1992 American Bar Association.

Goldman, Sachs & Co., Marketing Documents for Roadshow of Telmex ADS Offer (1991)

Copyright © 1991 by Goldman, Sachs & Co.

F. Graaf, *Euromarket Finance: Issues of Euromarket Securities and Syndicated Eurocurrency Loans* (1991)

Reprinted by permission of Kluwer Publishers.

S. Miller and L. Mullen, "Alternative Trading Systems," *Traders Magazine*, Vol. 17, No. 3 (March 1999)

Reprinted by permission of Securities Data Publishing.

E. Greene, A. Beller, G. Cohen, M. Hudson, Jr., and E. Rosen, *U.S. Regulation of the International Securities Markets* (1992)

Reprinted from *U.S. Regulation of the International Securities Markets* with the permission of Prentice Hall Law & Business.

G. Haberman, "Capital requirements of commercial and investment banks: contrasts in regulation," *Federal Reserve Bank of New York Quarterly Review*, Autumn 1987

Reprinted with permission from G. Haberman; reprinted with permission from Federal Reserve Bank; and reprinted with permission from Federal Reserve Bank of New York Quarterly Review.

S. Henderson, "Should Swap Termination Payments Be One-way or Two-way," *International Financial Law Review* (October 1990), 27-32

This article first appears in the October 1990 issue of *International Financial Law Review*. Copyright Euromoney Publications PLC, London, England.

J. Hull, *Introduction to Futures and Options Markets*, copyright © 1991

Reprinted by permission of Prentice-Hall, Inc., Englewood Cliffs, N.J.

M. D. Levi, *International Finance* (1990)

Reproduced with permission of McGraw-Hill, Inc.

R. Litan, "Nightmare in Basle," *The International Economy*, November/December 1992

Reprinted with permission by *The International Economy* magazine, November/December 1992, Washington, D.C.

T. Prime, *International Bonds and Certificates of Deposit* 45-54 (1991)

Reprinted by permission by Butterworth-Heinemann Ltd.; and reprinted by permission of T. Prime.

S. Radelet and J. Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects" *Brookings Papers on Economic Activity* 1:1998.

Reprinted by permission of the Brookings Institute.

H. Scott, "Supervision of International Banking Post-BCCI," *8 Georgia State University Law Review* 487 (1992)

Reprinted by permission.

R. Smyth, "Bank of England Blueprint for LSE Settlement System," *International Financial Law Review* (October 1993), 21-23

This article first appears in the October 1993 issue of *International Financial Law Review*. Copyright Euromoney Publications PLC, London, England.

D. Sneider, "Financial Services Reform in Japan," *International Securities Regulation Report* 6 (February 6, 1993)

Reprinted with permission from International Securities Regulation Report. Copyright © 1994 by LRP Publications, 580 Village Boulevard, Suite 140, West Palm Beach, FL 33409. All rights reserved. For more information on International Securities Regulation Report, please call 1-407-687-1220, ext. 716.

I. Swary and B. Topf, *Global Financial Deregulation: Commercial Banking at the Crossroads* (1992)

Reprinted by permission of Blackwell Publishers.

E. Symons and J. White, *Banking Law*, 3rd Edition (1991), 806-9

Reprinted with permission of the West Publishing Corporation.

M. Warren, "The Investment Services Directive: The 'North Sea Alliance' Victory over 'Club Med'," International Securities Regulation Report 6 (January 12, 1993)

Reprinted with permission from International Securities Regulation Report. Copyright © 1994 by LRP Publications, 580 Village Boulevard, Suite 140, West Palm Beach, FL 33409. All rights reserved. For more information on International Securities Regulation Report, please call 1-407-687-1220, ext. 716.

J. Willoughby, "Exchange or Die", Institutional Investor, November (1998).

Reprinted with permission of Institutional Investor.

INTERNATIONAL FINANCE

TRANSACTIONS, POLICY, AND
REGULATION

*

SUMMARY OF CONTENTS

PREFACE	iii
ACKNOWLEDGMENTS	v
CHAPTER ONE Introduction	1
A. The Definition of an International Financial Transaction	1
B. International Financial Markets: Types and Trends	11
C. Costs and Benefits of the Internationalization of Finance	21
D. The Impact of Internationalization: The Case of Korea in 1997 ..	22
PART ONE. INTERNATIONAL ASPECTS OF MAJOR DOMESTIC MARKETS	28
CHAPTER TWO International Aspects of U.S. Securities Regulation	29
A. Internationalization of U.S. Securities Markets	29
B. The Basic Securities Law Framework	49
C. GAAP Reconciliation	59
D. Opening up U.S. Securities Markets	63
E. Issuing Securities Abroad	77
CHAPTER THREE International Aspects of U.S. Banking Regulation	89
A. The Importance of Foreign Banks	89
B. Basic Features of U.S. Regulatory System	93
C. Regulation of Foreign Banks	96
D. The GATS	143
E. U.S. Banks Abroad	163
CHAPTER FOUR Infrastructure:* Capital Adequacy ...	216
Section I. Commercial Banks and Credit Risk	216
A. The Background of the Accord	217
B. The Basle Accord	219
C. The Performance of the Basle Accord	232
Section II. Capital Adequacy for Securities Operations ..	251
A. Risks Associated With Securities Operations	253

* There are four infrastructure chapters—capital, foreign exchange, the payment system and clearance and settlement—covering subjects that are important to international finance generally, not just to the Part of the book in which they happen to appear. We take them up when needed.

B. Capital Adequacy and Position Risk	258
C. Other Risks and Capital for Non-Credit Risks	280
D. The Search for a Common Treatment of Banks, Their Affiliates, and Unaffiliated Securities Companies	282
E. Overall Evaluation of the Market Risk Capital Adequacy Rules	285
CHAPTER FIVE The European Union: The Single Market in Financial Services	287
A. Introduction	287
B. Securities Markets	296
C. Banking Markets	314
CHAPTER SIX Infrastructure: Foreign Exchange Regimes	343
A. Exchange Rate Systems	343
B. Foreign Exchange Markets	354
C. Purchasing Power Parity and Interest Rate Parity	360
D. The European Monetary System in the 1990s: A Case Study of Exchange Rates	364
CHAPTER SEVEN Europe's Economic and Monetary Union	378
A. The Design of the European Monetary Union	378
B. The Transition: Getting to Stage Three	389
C. Stage Three: How Does It Work?	394
CHAPTER EIGHT Japanese Banking and Securities Markets: International Aspects	423
Section I. Banks	424
A. History	424
B. Issues in the 1990s	439
Section II. Japanese Securities Markets	462
A. Japanese Securities Markets to the Early 1990s	463
B. Foreign Access to Securities Markets in Japan	466
C. The Japanese Role in Foreign and International Securities Markets	480
D. The Stock Market Crisis and the Government's Response	487
E. The Big Bang and Japan's Securities Market	490

PART TWO. INSTRUMENTS AND OFFSHORE MARKETS . . 497

CHAPTER NINE	Eurodollar Deposits and	
	Syndicated Loans	498
A.	Introduction to the Eurocurrency Market	498
B.	The Growth of the Market for Syndicated Eurodollar Loans . . .	515
C.	The Allocation of Risk Among the Parties to a Eurocredit	528
CHAPTER TEN	Infrastructure: The Payment System .	544
A.	The Use of the U.S. Payment System for International Transactions	544
B.	Fedwire and CHIPS: Risk Reduction Measures	566
C.	Herstatt Risk	584
D.	Some Aspects of the International Payment System	592
CHAPTER ELEVEN	Asset Freezes	607
A.	Freezes by the Currency Country: <i>LAFB</i>	607
B.	Freezes by the Host Country	637
CHAPTER TWELVE	Eurobonds and Global Securities	653
A.	Eurobonds	653
B.	Global Bonds	690
CHAPTER THIRTEEN	International Asset	
	Securitization	703
A.	Introduction	703
B.	Elements of a Securitized Transaction and the Reasons to Securitize	705
C.	The Development of National ABS Markets	714
D.	An Overview of the BHP ABS by Deutsche Bank	725
E.	Deutsche Bank's Euro-ABS Activities	727
F.	The BHP Asset Backed Securities	741
CHAPTER FOURTEEN	Stock Market Competition	748
A.	U.S. Market	749
B.	Foreign Markets	773
C.	Worldwide Competition Between Stock Markets	784
CHAPTER FIFTEEN	Infrastructure: Clearance and	
	Settlement	801
A.	The Basic Elements	801
B.	Group of Thirty Proposals	827
C.	International Dimensions	839

CHAPTER SIXTEEN	Derivatives: Futures and Options	874
A.	Introduction	874
B.	Futures, Options, Their Markets: An Introduction	875
C.	The Mechanics and Use of Interest-Rate Futures and Options based on Them	892
D.	Futures and Options Exchanges: Competition and Regulation	907
E.	A Case Study in the Regulation of Futures and Options Markets: The Barings Case	915
CHAPTER SEVENTEEN	Swaps	949
A.	Swap Transactions and Markets	949
B.	Credit and Market Risks in Swaps	966
C.	Disclosure Requirements	986
D.	Capital Requirements for Swaps	995
E.	Enforceability Issues	1002
CHAPTER EIGHTEEN	Offshore Mutual Funds	1038
A.	United States Regulatory Barriers to Offshore Mutual Funds	1039
B.	Tax Considerations	1071
PART THREE. EMERGING FINANCIAL MARKETS		1083
CHAPTER NINETEEN	Project Finance	1084
A.	Introduction	1084
B.	The Philippines	1085
C.	The Philippines' Need for Power	1088
D.	Project Finance in General	1090
E.	The Pagbilao Power Project	1100
F.	Financing Pagbilao	1107
CHAPTER TWENTY	Emerging Markets: Privatization and Institutional Investors	1129
A.	Introduction	1129
B.	Privatization in the 1980s and 1990s	1130
C.	Mexico's Evolving Economy	1136
D.	Telmex Under Government Control	1140
E.	Traditional Options the Government Could Use to Sell Its Telmex Stake	1143
F.	The Transfer of Control Over Telmex to the Consortium	1148
G.	The Offer of Telmex Shares in World Markets	1156
H.	Demand for the Telmex Offer	1160
I.	The December 1994 Peso Crisis	1173

CHAPTER TWENTY-ONE	The Asian Currency Crisis ..	1183
A. The Sources of the Crisis		1183
B. International Solutions		1203
INTERNATIONAL FINANCE GLOSSARY		1231
INDEX		1251

TABLE OF CONTENTS

PREFACE	iii
ACKNOWLEDGMENTS	v

CHAPTER ONE Introduction 1

A. The Definition of an International Financial Transaction	1
1. International Transactions	2
B. International Financial Markets: Types and Trends	11
1. The Long-Term Shift of Financial Markets from Domestic to International to Global	11
2. Foreign Exchange Markets	14
3. Markets for Indirect Finance: International Bank Lending .	15
4. Markets for Direct Finance: International Bonds	18
5. Markets for Direct Finance: Cross-Border Equities	19
6. Markets for Direct Finance: Derivatives	20
C. Costs and Benefits of the Internationalization of Finance	21
D. The Impact of Internationalization: The Case of Korea in 1997 .	22

PART ONE. INTERNATIONAL ASPECTS OF MAJOR DOMESTIC MARKETS 28

CHAPTER TWO International Aspects of U.S. Securities Regulation 29

A. Internationalization of U.S. Securities Markets	29
B. The Basic Securities Law Framework	49
1. General Rules	49
2. Special Rules for Foreign Issuers	56
C. GAAP Reconciliation	59
1. Daimler-Benz Case	59
2. International Accounting Standards	62
D. Opening up U.S. Securities Markets	63
1. Rule 144A and Private Placements	64
2. The MJDS Approach	68
3. The Use of ADRs	73
E. Issuing Securities Abroad	77
1. The Regulation S Framework	78
2. Regulation S Reforms for U.S. Companies Issuing Securities Abroad	82
3. Directed Selling	84
4. Regulation S - Rule 144A Offerings	84

CHAPTER THREE	International Aspects of U.S. Banking Regulation	89
A.	The Importance of Foreign Banks	89
B.	Basic Features of U.S. Regulatory System	93
C.	Regulation of Foreign Banks	96
1.	Safety and Soundness	96
2.	Federal Deposit Insurance	118
3.	Permissible Activities	127
4.	Interstate Banking and Foreign Banks	140
D.	The GATS	143
E.	U.S. Banks Abroad	163
CHAPTER FOUR	Infrastructure:[*] Capital Adequacy	216
	Section I. Commercial Banks and Credit Risk	216
A.	The Background of the Accord	217
B.	The Basle Accord	219
1.	General Elements and the Definition of Capital	220
2.	Risk-weighting	226
3.	The Treatment of Off-Balance Sheet Items	230
C.	The Performance of the Basle Accord	232
1.	The Transition to Full Standards	232
2.	The Accord and the Credit Crunch	233
3.	Toward A More Level International Playing Field	235
4.	Capital for Credit Risk and Internal Models	245
5.	The Basle Committee's 1999 Proposal to Amend the Accord	249
	Section II. Capital Adequacy for Securities Operations	251
A.	Risks Associated With Securities Operations	253
B.	Capital Adequacy and Position Risk	258
1.	Position Risk and the Building Block Approach	258
2.	The Comprehensive Approach to Position Risk: the U.S.	263
3.	A Comparison of the Building Block and Comprehensive Approaches to the Portfolio Approach	267
4.	Internal Models-Based Regulation of Capital	272
C.	Other Risks and Capital for Non-Credit Risks	280

* There are four infrastructure chapters—capital, foreign exchange, the payment system and clearance and settlement—covering subjects that are important to international finance generally, not just to the Part of the book in which they happen to appear. We take them up when needed.

1. Other Securities Risks Addressed by Capital	
Adequacy Rules	280
2. The Definition of Capital for Non-Credit Risk	281
D. The Search for a Common Treatment of Banks, Their Affiliates, and Unaffiliated Securities Companies	282
E. Overall Evaluation of the Market Risk Capital Adequacy Rules	285

**CHAPTER FIVE The European Union: The Single
Market in Financial Services** 287

A. Introduction	287
B. Securities Markets	296
1. Disclosure	296
2. Provision of Services	308
C. Banking Markets	314
1. The Second Banking Directive	314
2. Deposit Insurance	326

**CHAPTER SIX Infrastructure: Foreign Exchange
Regimes** 343

A. Exchange Rate Systems	343
1. Fixed Rate Systems: The Gold Standard	344
2. Fixed Rate Standards: The Bretton Woods Dollar Standard	347
3. Floating Rate Regimes	350
4. The Debate in the 1990s About Replacing the Non-System	353
B. Foreign Exchange Markets	354
1. The Spot Foreign Exchange Market	356
2. The Forward Market	359
C. Purchasing Power Parity and Interest Rate Parity	360
D. The European Monetary System in the 1990s: A Case Study of Exchange Rates	364
1. The Mechanics of the EMS	364
2. The Reasons for Joining the EMS	369
3. Attacks on the ERM: Black Wednesday, September 16, 1992	370
4. The ERM Crisis of 1993 and its Aftermath	374