



Chapman, Spira & Carson, LLC

International Finance

We, as advisors to clients abroad seeking acquisitions in the U.S., identify and research suitable candidates, and then take an active role in negotiating and executing transactions.

Included among our clients are U.S. corporations seeking synergistic acquisitions, divestitures and joint venture partners abroad.

OF INTEREST TO ALL.

Transparency is a prerequisite to the continued success of banking and related services.

Our Fearless Leader Takes Charge

"The Bank for International Settlements (BIS) agreed last year to allow banks to use their own internal models to measure how much capital they need as a cushion against swings in financial markets. The new rules should come into effect at the beginning of next year, but the Federal Reserve is allowing some US banks to introduce the system before then, if they can satisfy supervisors that their models work properly. Bankers Trust (the first) won approval to use the new technique for calculating its capital adequacy ratios at the end of the first quarter." (The Financial Times)

As you will recall, Bankers Trust was the bank that was sued by some of its largest clients including Procter and Gamble who has historically has been loath to make waves, for massive losses that they suffered at the hands of the Bank's derivatives area. Bankers Trust's trading for its own account hasn't been much better as the recently announced enormous losses incurred while dealing in Eastern European financial instruments. These transactions cost Bankers a hefty part of their capital and their stock has almost collapsed.

The Bank for International Settlements is an organization of central banks based in Basle, Switzerland. It was established in 1930, and thus is the oldest functioning international financial organization. The BIS was formed for the practical purpose of coordinating Germany's World War 1 reparations payments (hence the term "settlements" in the organization's name). However, its primary objectives, which have guided the Bank's activities since its inception and are reflected in its current role, were to promote cooperation among central banks and to provide additional facilities for international financial operations. The Basle Committee on Banking Supervision developed the international agreement on minimum capital standards for internationally active banks and continues to be the forum for designing a cooperative framework for supervision of international bank activities.

The Bank has not been a stranger to controversy and Alan Cowell seems to have put some of its historic background into focus. "In another tangled chapter in the "Nazi gold" affair, the Swiss-based Bank for International Settlements, which American officials suspected during World War II was acting in collaboration with Nazi leaders, confirmed today that gold transactions with the Germans included looted gold and ingots re-smelted in Nazi Germany to disguise their origin. 'It is fair to say our original focus has been to establish facts rather than to try to guess the motivations and opinions' of the wartime management, the bank's general manager, Andrew Crockett, said at a news conference in Basle today. Indeed, some American officials called for the bank's liquidation immediately after the war, accusing it of being dominated by Nazi interests. It is not clear from today's statement whether the wartime transactions listed by the bank were a front for other financial transfers linked to the German war effort" New York Times, Alan Cowell May 13, 1997,

Under the BIS aegis, banks can put up less and less money in their transactions, provided they satisfactorily demonstrate that the model they are using will work. What is frightening about this concept is the fact that it isn't the model that fails; it is the people implementing the model's dynamics that fail. Reducing financial requirements will only bring about additional leverage and far more severe problems. Henry Gonzalez, then House Banking Committee chairman said "A monstrous global electronic Ponzi scheme", when referring to derivatives.

HEDGE FUND! WHAT'S A HEDGE FUND?

Long-Term Capital soon proved Gonzalez right when not only did it collapse on September 23, 1998, but also the sums that they dealt in were so large that they almost brought the rest of the global economic community down with them. Only fast action by the New York Federal Reserve and the deep pockets of knowledgeable Wall Street executive saved the day. The New York time wrote an editorial on the matter on September 25, 1998, which puts the matter into perspective.

"The concept of "too big to fail" has now been extended to a huge hedge fund that was run by people thought to be financial wizards. (Two founders were Nobel Prize winners in economics) The bailout of the fund by a consortium of the country's leading financial institutions is a reminder of how fragile the world's financial markets now are, and of the risks of making big bets that markets will act in predictable ways."

"The hedge fund was run by John Meriwether, the former Salomon Brothers official widely viewed as a Wall Street genius. His forte was in trading bonds, buying those that were relatively cheap and selling those that were relatively expensive. The idea was to make a little money on each trade, and make a lot of money overall by using borrowed money to buy bonds in large quantities. For every dollar put up by investors in the fund, Mr. Meriwether seems to have borrowed more than \$20."

"In determining what investments to make, Mr. Meriwether and his colleagues, had sophisticated computers that reviewed historical prices of bonds and other financial instruments and found relationships between them. Strategies were then calculated on the assumption that events that had never happened before could not happen at all. However, they did. Bond prices almost always rise and fall together. But in the current financial crisis, the prices of United States Treasury bonds have soared as investors bought them in search of safety while the prices of most other bonds - backed by corporations or by other governments - have fallen, as investors grew nervous about the risks involved.

Unfortunately, Mr. Meriwether, who at the peak was managing more than \$1900 billion - the vast majority of it borrowed money - had bet against such an occurrence. After all, that is what happens almost all the time.

The odds were with Mr. Meriwether, whose fund returned profits of more than 40 percent a year in 1995 and 1996, and of 17 percent in 1007, even after hefty management fees. But betting the way he did turns out to be a little like Russian roulette; the odds of winning are very good, but you can't play again if you lose.

Effectively, Mr. Meriwether's fund has been taken over by the banks and brokerage houses that lent money to it. Investors in the fund - who had to put up a minimum of \$10 million each - are likely to lose virtually all the money they invested. There is no public money in \$3.5 billion bailout, but it was organized by the Federal Reserve, which stepped in because of fears that shaky financial markets would suffer even more if Mr. Meriwether's fund was forced to liquidate its holdings.

At best, markets will return to normal and the banks that kept Mr. Meriwether's fund afloat will make some money, perhaps even enough to share the original investors. At worst, markets will continue to sink and the bailout money will vanish.

The great bull market of the 1980's and 1990's has been built in significant ways on leverage, as big players found ways to borrow to the hilt. Not the banks that made the loans are getting nervous and demanding more collateral before lending to other hedge funds. That contraction in credit is prudent, but it will put more pressure on financial markets that are already feeling the strain.

"WHAT DOES YOUR CRYSTAL BALL SAY ABOUT THE EURO?"

Gay Evans is the Chairwoman of the International Swaps and Derivatives Association. Gay is also a Managing Director of Bankers Trust International. It appears that 15 percent of the \$40 trillion in outstanding derivative contracts are denominated

in currencies that will comprise the "Euro". Inevitably, some of those contracts were written to extend beyond the scheduled initial start-up date of trading in the projected currency.

Obviously, this raises certain significant questions:

1. What will be the legality of a contract to purchase a currency if that currency no longer exists?
2. How will new derivative currency contracts be written as trading becomes inevitable. (A single currency for government bond issues is scheduled for January of 1999)
3. Will each derivative contract contain either/or language, in one case, if the Euro comes to pass, and the other case, if it doesn't?
4. Will the derivative require a double hedge?
5. What court will handle the dispute if the parties can't agree?

Each new action by the public sector at a global level requires a leveling action by the private sector. The contracts between parties to derivatives that tend to extend out a substantial number of years cannot possibly predict the composition of that future marketplace. Worse than that, we have no conception of the nature of the regulator of that period, or even if there will be one. The Bank for International Settlements has no particular mandate in any area with the exception of certain war reparations, and to think that it would have global legal standing relative to non-bank derivative trading is beyond naïve'.

The "Euro" is an accident waiting to happen. Unwinding hedged positions will be murder, back office problems will probably create momentous transactional deficits while opportunists such as Meriwether will roll out statistics that say, "it always worked that way before, thus it will work in the future". We believe that trading loses and profits in the "Euro" will become monumental, but someone is going to leverage his action to the hilt and guess wrong, throwing the entire monetary system of Europe off kilter for years to come and bring down its markets as well. Long-Term Capital Management was not the only gambler to guess wrong, but it was the biggest; so far.

IT'S A NEW WORLD

Instantaneous electronic information flow has caused a change in the way we think, the way we live and the way we foresee the future. Regulators, cognizant of the immense changes occurring globally, are attempting to modernize their rules to fit the dynamically fluid circumstances. However, as change accelerates, regulators' grip on the machinery of change loosens or at best becomes confused. "Time sensitive" data becomes scarcer and scarcer. Regulatory bureaucracies do not operate in real time; they are, therefore, left in the dust.

If American regulations do not change, each participant will be playing under a completely different set of internal accounting rules, all of which are highly complex and substantially opaque to other participants. Far from transparency and harmonization, in the United States we are heading back into an financial anarchy. In addition, as illustrated below, the increasing interdependence of financial institutions and accelerated capital movement guarantee that when disaster strikes, it does so quickly and massively.

Banks around the world have recently taken a terrific pounding in Asian loans, Eastern European repudiation and trading loses. It has not been the best of all times for banks anywhere. In spite of the fact that most large banks are either traded in global securities markets or are appendages of a government, the majority of recent loses have been publicly opaque for numerous reasons not the least of which is the fact that accounting does not require derivative holding to be part of the bank's disclosable balance sheet. These are called off-balance sheet items. In Asia, concerned governments have allowed their banks make up new definitions for words like "non-performing" and even if they have such nomenclature, to send into oblivion the time necessary for a lender to go into regulatory default.

So the financial institutions of the world continue to spew out meaningless reports on how they are doing while inside the caldron a fire is ever smoldering. The fact that our systems are able to cope with these numbers and not suffer from chronic disarray is one of the miracles of our age. However, our brethren at the Bank of International Settlements are extremely concerned that we are taking a run of good luck with a far too cavalier attitude. While there seems to be a degree of harmonization within global settlements, there is no synchronization, thus casting a pall over the entire field of foreign exchange and there is no question that it is only a matter of time before the "other shoe will fall". Foreign exchange volume is only gearing up as many of the world's largest countries only now enter the arena. Russia, China and India, all of whom had been primarily on the sidelines, are now becoming active participants in the market. Their addition, plus several others,

geometrically increases the size of the market and its effect will be visible in the short years ahead. Small slips by fast cars make big accidents and often leave traffic tied up for miles.

Suddenly, all of the world's country's seem to have become globalized simultaneously, geometrically increasing the number of players in the foreign exchange markets. Our ever more sensitive computers continue to keep pace with the skyrocketing volume of international settlements, but the quality of the data continues to erode as less sophisticated players enter an established highway without a road map. Ultimately, we will be faced with a problem of too many cooks, putting too much "garbage" in to the mix and as a result, as they say in computer jargon, garbage will come out.

The new players have their own style and venue and have not been coached in the "Marquis of Queensbury Rules" by which the money game has historically been played. Many of these transactions are done by countries so new to the game of international trade that their own laws do not appropriately cover all of the machinations that are conceivable. Thus, when private sector transactions are done in foreign exchange, can the other side always be sure that there are not impediments to settlement beyond mechanically priming the pump.

Just determining where equilibrium lies in transactions, which consist of foreign exchange settlement exposure, when the "risk that one party to a foreign exchange transaction will pay the currency it sold but not receive the currency it bought" is the stuff that nightmares are made of. The international systems are not synergistic and work on various levels of efficiency. The bottom line though, is that these are clearly not "deliveries against" payment, the only thing holding the transaction together is the agreement of the parties to consummate the transaction. One may take the high road and another the low road, but even if one gets to Scotland afore the other, it has not been consequential because of the historic creditworthiness of the parties involved. Creditworthiness was simple to define in more classical times when everyone in the business (banks), in a manner of speaking, belonged to the same club. In this globalized society where the players may not don white gloves, do we really want our money traveling down different roads in order to get to the same place at the same time.

So in August of 1982, Mexico's Finance Minister, in a meeting with the U. S. Treasury, informed officials that Mexico could not repay its external debt of over \$88 billion. "It is hard to say who was in worse trouble, Mexico or its creditors. However much its people would suffer as a result of its default, there still would be a Mexico. The same could not be said with certainty of the banks that had lent it money. Mexico owed its largest American creditor, Citibank, \$3.3 billion - more than two-thirds of Citibank's net corporate assets. The Bank of Tokyo was even worse off; 80 percent of its net assets were at risk in Mexico. In theory on that day, the loans became under-performing and the banks literally insolvent."

In an unforgiving, electronically regulated global banking system, Citibank's connection to the international source of funds would have been terminated. All of its positions would have been considered in default and the cyber-police would have started fighting a losing battle to unwind billions and billions of dollars of derivative transactions carried on the banks' books. It would be difficult enough if the cyber-police could even decipher the nature of derivatives. However, unless the cadre' of highly educated tinkerers that created the derivatives were kept together, this process would be impossible. Many of the derivatives could have been issued as straight gambles on the part of the bank with no compensating collateral. Some of the transactions may have been so complex that only the maker could unwind them; had he left the bank, the task would have been impossible, particularly because these are time denominated instruments.

"Obviously, we could not allow Citibank to go under, and the American Banking System in general, to suffer irreparable damage to their ability to lend. The solution was simple; we paid Mexico in advance for oil that was to be delivered at some time in the future, to our strategic petroleum reserve. We then arranged for the Federal Reserve Bank to forward Mexico enough to bring their debt current as well as to take care of certain social amenities; and lastly, we imposed upon the International Monetary Fund to arrange an entire restructuring of Mexican Debt". Masters of Illusion, Catherine Caufield

Interestingly enough, we caused the Mexican default indirectly forcing money down their throats. This came about when the Federal Reserve (Fed), in order, to bring the market out of the doldrums, which was as a result of the 1970 stock market crash, dropped interest rates and expanded the money supply. Having no solid source of investment, instead of putting the money to work in the United States, investors bought so many Euro-dollars that interest rates in Europe fell, while in turn, its money supply rose. The only outlet available was in Latin America, and never folks to turn down a bargain, the South Americans joined as invited guests to a royal monetary disorgement. Mexico was the star performer on the bread line.

WE ALL BELIEVE IN MAXIMUM TRANSPARENCY, ER... FOR EVERYONE ELSE THAT IS

Strangely enough, with all of this talk of transparency and harmonization, derivatives are not required by GAAP to be shown on corporations' financial statements. Derivatives are off balance sheet items. In the world of "Alice in Wonderland", it would theoretically be possible for a financial institution to have billions of dollars of these obligations floating around in all parts of the globe; yet have miniscule assets and little cash.

The reason for the opacity of derivatives is that there is generally no historic cost attributable to their creation or sale. Each instrument is unique, making valuation difficult. The Financial Accounting Standards Board (FASB) has been attempting to force reporting standards on the industry, in spite of a General Accounting Office (GAO) study advocating disclosure. Representative John Dingel of Michigan even went so far as to bring the matter up with Secretary of the Treasury, Robert Rubin, inquiring as to a "need for improved derivatives accounting and disclosure." Makes you kinda wonder what's going on.

This type of opacity on a worldwide scale, with billions of dollars at risk, could cause a meltdown so rapid as to be uncontrollable. This is particularly true because of the risks that attend transnational trading:

"BANK FRAUD UP A NOTCH OR WAS IT JUST A MISTAKE?"

NOBODIES PERFECT, YOU KNOW

A more complex problem occurred in 1974, a year in which foreign exchange contracts were literally less than one percent of the volume we see today. On June 26 of that year at approximately 11:00 am Eastern Standard time, Bankhaus ID Herstatt KGaA was closed, a penalty imposed on it primarily for consistently guessing wrong while speculating on currency movements (). Being unaware of the closing and having outstanding foreign exchange transactions to settle, payments were made and when it was found that Herstatt was already out of business, fruitless attempts to unwind the transactions were made, both at the central bank and judicial levels, to no avail. The ruling, once the transactions became part of the system, they no longer were the property of the issuing parties. This problem caused a twenty-car pileup, as overdrafts became systemic and financial gridlock appeared the order of the day. The entire German banking system reverberated and nearly fell from fallout brought on by this inconsequential financial institution. The simplest solution would have been one of retrenchment until the smog had left the battlefield: tightly shield one's collateral and "fail" on settlements, until it was clear who was left on the playing field. Cooler heads would have prevailed and cooperation between club members would have prevented a system wide collapse. As it was, chaos reigned supreme.

Bankhaus Herstatt failed to deliver US dollars to counterparties after it was ordered into liquidation by the German authorities in 1974. On June 26, 1974, at approximately 11:00 am Eastern Standard time, Bankhaus ID Herstatt KGaA was closed, and a penalty was imposed on it primarily for consistently guessing wrong while speculating on currency movements. Being unaware of the closing and having outstanding foreign exchange transactions to settle, payments were made. When it was found that Herstatt was already out of business, fruitless attempts were made to unwind its currency transactions, both at the central bank and judicial levels, to no avail. The ruling: once the transactions became part of the system, they were no longer the property of the issuing parties. A new phrase crept in the language, the "Herstatt risk", the potential that a bank will deliver currency on one side of a foreign-exchange transaction, without receiving recompense on the other.

Banks are exposed to large amounts of cross-border settlement risk because irrevocable settlement of the separate legs of a foreign exchange transaction may be made at different times. For example, delivery of yen to a New York bank's Japanese correspondent bank in Tokyo occurs during Tokyo business hours, while the corresponding delivery of dollars by a New York bank to a Japanese counterparty's US correspondent bank in New York occurs during New York business hours. Since the two national payment systems are never open at the same time, there is the risk that after the first counterparty has delivered one side of the transaction, the other counterparty may go bankrupt and fail to deliver the offsetting currency.

More than 20 years after the collapse of Herstatt, there is still no widely accepted method of quantifying settlement risk. The Foreign Exchange Committee, a private sector group sponsored by the Federal Reserve Bank of New York, was the first to survey foreign exchange dealers and provide a methodology for examining settlement risk, as well as a set of recommended best practices, in its report, "Reducing Foreign Exchange Settlement Risk." More recently, in March 1996, the Committee on Payment and Settlement Systems of the Group of Ten (the ten industrial countries with the largest economies) released the Allsopp Report, which, building on the earlier methodology, analyzes existing arrangements and sets out a strategy for reducing settlement risk.

TIMING IS EVERYTHING

"The Allsopp Report found that foreign exchange settlement is not just an intra-day phenomenon and that payment lags can initially last at least one to two business days; another one to two business days may then elapse before a bank is assured that it has received the requisite payments. The amount at risk at a bank could exceed three days' worth of trades, so that the exposure to even a single counterparty could exceed a bank's capital. While the risk is only beginning to be recognized and quantified, recent foreign exchange payment defaults, including those of the Bank of Credit and Commerce International (BCCI) and Barings Plc, demonstrate that the risk cannot be ignored." (Laura E. Kodres, International Capital Markets, IMF)

IF YOU DIDN'T UNDERSTAND THE DERIVATIVE WORKS HOW ARE YOU GOING TO MAKE OUT WITH THE REPO?

The investment industry works pretty much like any other business when you really get down to it. Orders come; they are executed, and then sent to the operations people for fulfillment. Being that so much money can be involved, the small firms have the larger ones take on that responsibility (clearing firms) and effectively guarantee their existence, as well. As an example, if I called you and said I wanted to buy \$100 million of Government securities and told you that I was Drysdale, you would probably say "who", just before hanging up the phone. If, on the other hand, I called and said that I was Drysdale Securities and I want to buy \$100 million of Government securities and make the delivery against payment to my clearing firm, Chase Manhattan, you would say, "when do you want them?" That is really the essence of how the "street" functions; the big boys clear for the little guys and usually make a lot of money doing it.

There really is a Chase Manhattan Bank, and believe it or not, there really was a Drysdale. Drysdale Government Securities was a minor bond dealer that used some very esoteric strategies that just worked fine on paper. In practice, they were never able to get it right and they went down the drain May 17, 1982.

It seems that Drysdale didn't really have any money, but had borrowed over \$2 billion to see if they could make it work. It didn't, and Chase, along with two other banks in for much smaller amounts, Manufacturers Hanover and United States Trust, were in the soup. Chase did what every other red blooded American bank would have done under the circumstances, they panicked and announced the unthinkable, they were not responsible. Understand, the street had operated in this fashion since the New York Stock Exchange had opened its doors and the rules had always remained the same. And worse, if Chase could walk away from a legal debt, then so could everyone else. Simply put, the system would fall into the East River of New York.