DEREGULATION OF DEALINGS IN FOREIGN CURRENCIES - LEGAL ISSUES

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Thank you Mr Chairman. Ladies and gentlemen. My colleague Paul Cooper and I have discussed the basis for running this panel session and decided that in view of the limited time available to cover the many issues in the broad ranging area of "deregulation of dealings in foreign currencies" that I had best briefly outline from a banker's point of view what has happened to foreign currency lending to Australian residents over the last three years. Paul, on the other hand, will give you a commentary on the legal issues involved.

At the outset it is important to recall that prior to December 1983 Australian residents were generally not permitted to hold or borrow foreign currency without the prior approval of the Reserve Bank of Australia. Under exchange control regulations, which were administered also by the Reserve Bank, foreign currency could only be bought or sold through the Australian banking system - a monopoly for the bank and a very comfortable way of life.

Also prior to December 1983 the Australian dollar was a managed currency against the basket of currencies comprising, on a weighted basis, Australia's major trading partners. The rate was set by a group of three - one from the Reserve Bank, one from the Australian Treasury and one from the Prime Minister's Department. It was managed in that the price for buying and selling foreign currencies against the dollar was fixed for the day. Movements between days were generally small and although appreciations and depreciations did occur, they occurred in an orderly fashion. The Aussie dollar was a stable currency. Again a very comfortable position for the banks and their clients.

All this changed in December 1983 when the Government deregulated the Australian dollar by allowing it to float freely against all currencies. The immediate effect was extreme volatility. Foreign exchange traders aged overnight. Their only compensation was that they were in greater demand and salary packages skyrocketed. Foreign exchange margins declined.

Accordingly, because of the volatility, many losses were incurred in those post-float days until traders became more accustomed to dealing in an unstable market. Movements of 2 to 3 cents in the Australian dollar on any day were not uncommon. New players in the foreign exchange market, introduced in 1984 to add depth, also found it very unstable and perhaps did not contribute anything to stability, for in many cases they did not answer telexes or were out to lunch when the going got tough, or to the bathroom as the Americans say.

What was the effect on clients who had borrowed foreign currency? Well they suffered severely. Many bled with the size of the margin calls and parity adjustments. The crucial point to note is that these borrowers did not learn from that experience. Demand increased significantly. Borrowers came back in droves eagerly seeking out and in many cases demanding foreign currency loans. Farmers particularly wanted a piece of the action. I think that is one of the reasons the state of the farming sector is so bad at the moment.

Clients were keen to take up large parcels of foreign currencies without understanding fully the extent of the underlying risk. Financial advisers in some cases did not act in the best interests of their clients. Bankers themselves have not been without tarnish in this regard for you will be aware that the most important aspect in examining any loan proposal from a banker's viewpoint is that the borrower must have the capacity to repay.

Banks don't lend on the basis that they will have to sometime in the future call on the security underlying the transaction. In many cases unfortunately this principle was either conveniently overlooked or not understood. The significant movements in the Australian dollar have created this call on security.

Why has this been so? What is the driving force behind the growth of the foreign currency loan business to Australian residents? Well the main reason is the perception that a foreign currency borrowing provides a cheaper source of finance because interest rates off-shore are markedly lower than the Australian interest rate and this has been the case for some three or four years. The exchange risk is either not understood or in typical Australian fashion they gamble that at the end of the loan when the repayment is due foreign currency rates will have moved in their favour. You only have to walk yourself down the corridor to the casino to appreciate that most Australians love to gamble, whether it be a game of dice, a go at lotto, or a flutter on the horses. Why not a punt on a foreign currency loan!

Recent studies have shown that in gambling terminology a foreign currency borrower has one chance in four of coming out in front. Not very good odds. When you look at the size of the stakes and the end result on the borrower, these are indeed dire consequences. The only winners in fact are the legal and accounting fraternity who with the propensity to charge

appropriate fees are good at cleaning up the mess after the event.

I think it is appropriate to look at the consequences of borrowing foreign currencies. The following slide will show that if you were a borrower of foreign currency for the full year 1985 you would have found of course that you would have to pay an interest rate something in the order of about 16-17% for Australian dollars, you would have been able to get Japanese yen at 6-7% and Deutschmarks at around about 5% - significantly cheaper on the surface. However, the crunch comes, when you look at the next slide, which shows the depreciation of the Australian dollar in 1985.

If you combine this with slide 3, you will see that the effective costs of borrowing for the pounds English, which is the second bar chart, is in the order of 70% for that particular period. If you look at the Deutschmarks you are paying about 60%. For the yen you must also be paying around 60%, US dollars a bit less, but Australian dollars round about the 16% or 17% mark. So you can see that it was quite a crunch to be in any of these major foreign currencies during 1985.

In real terms, and I will just show the next slide briefly, the total cost of a borrower going into a AUD2,000,000 facility and converting that into Swiss francs in January 1985 and repaying it in early 1986, would have been a net cost to the borrower of an additional AUD933,000 on his AUD2,000,000 borrowing. That is, not on an after tax basis, because in that particular year there was no tax deductibility for foreign currency gains or losses. So you can see that it was indeed a crippling burden.

What are some of the measures that banks have taken to reduce the risk? First, banks have become more selective in their choice of borrower to whom they are prepared to lend foreign currency. The small speculative customer is discouraged. The gamblers, customers without any foreign domicile assets or foreign currency income to provide a natural currency hedge are discouraged. The minimum facility has been raised from AUD250,000 to AUD500,000. Security cover has been increased to reflect the worst case scenario. In other words, only those clients who appreciate the risks and can afford then are granted facilities.

Secondly, risk management units within banks have been enhanced to assist clients manage their foreign currency exposure. Hedging their exposure through a basket of currencies is encouraged.

Thirdly, a concerted effort has been made to remind existing customers and to fully inform new clients of the risks of borrowing foreign currencies. Their obligations with parity adjustments, particularly interim adjustments between roll-overs have been stressed. Clients have indeed been encouraged to establish sinking funds to act as a buffer for exchange rate movements where they borrow in foreign currency.

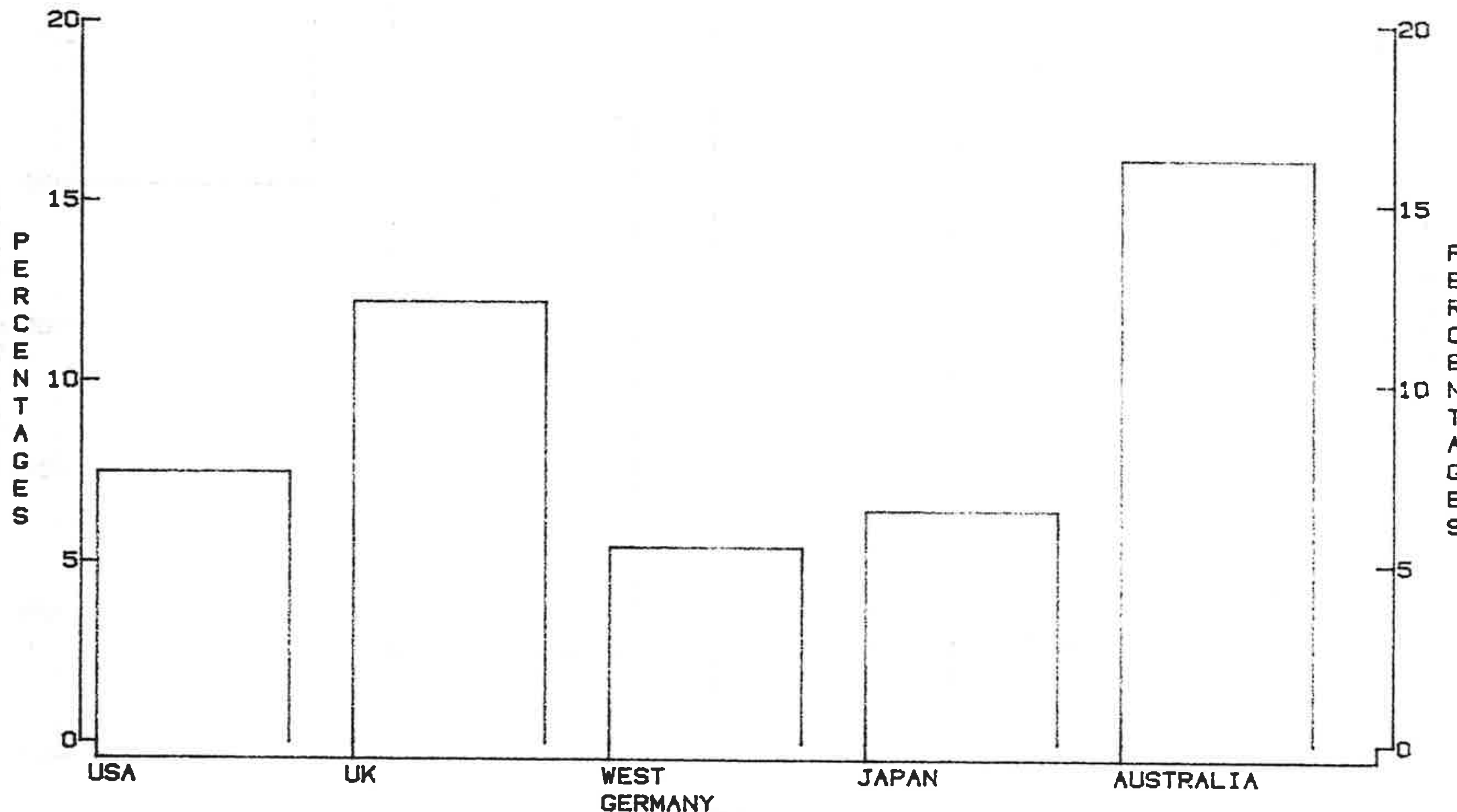
Lastly, third party guarantors and mortgagors have been reminded of their obligations and risks attaching to foreign currency borrowings.

Overall banks are concerned at the level of foreign currency borrowings and I have estimated these to be around about 10 billion Australian dollars. A number of skeletons are yet to surface from this group. However, banks have taken steps to ensure that existing and new clients are fully aware of the risks and that speculative borrowers are not allowed to repeat the dismal performance following the float in 1983. We hope that advisers, brokers, accountants and lawyers are also making their contribution to ensure that the events of the past three years are not repeated.

SLIDE 1

COMPARATIVE INTEREST RATES

AVERAGE FOR 1985

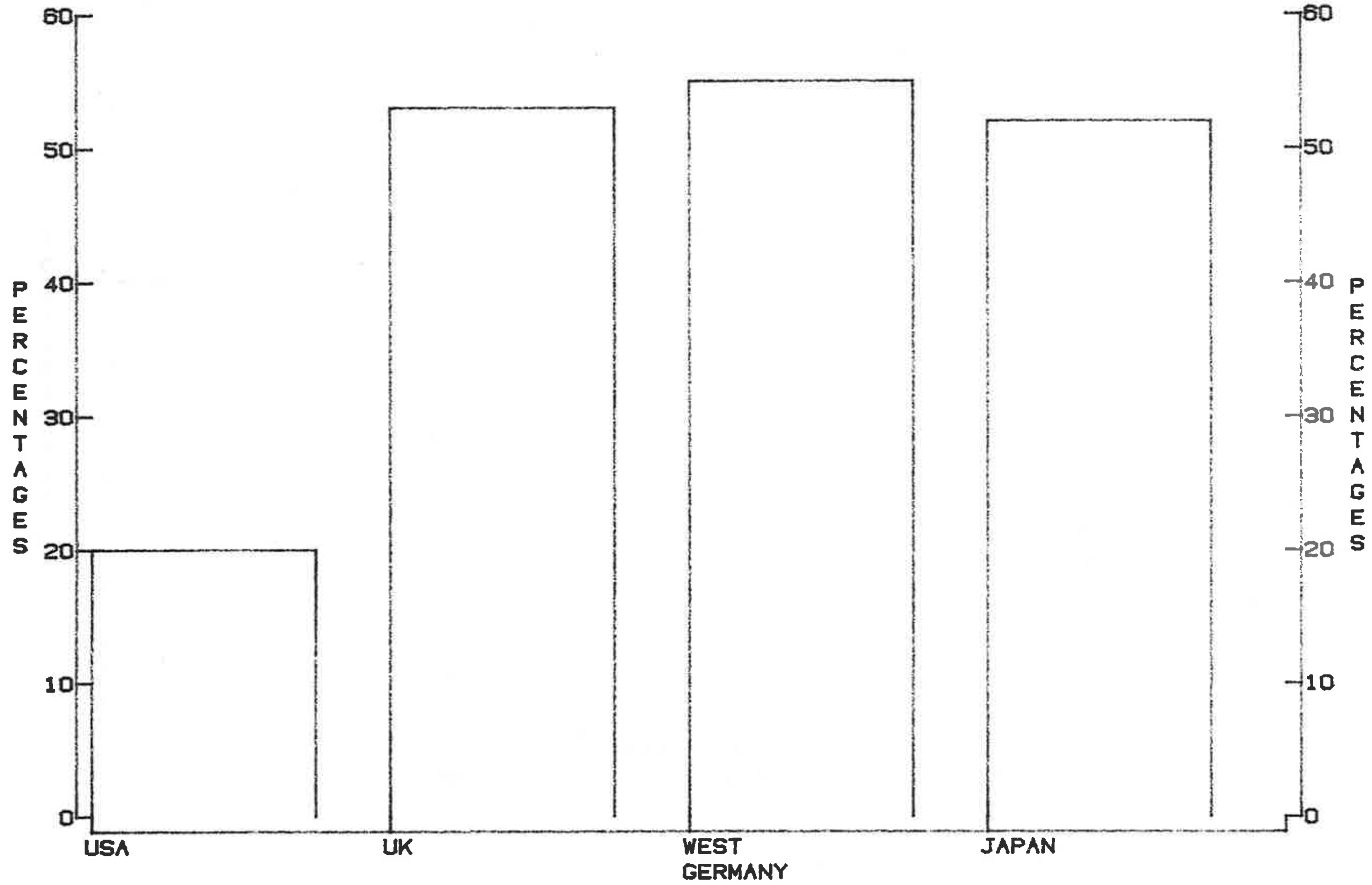


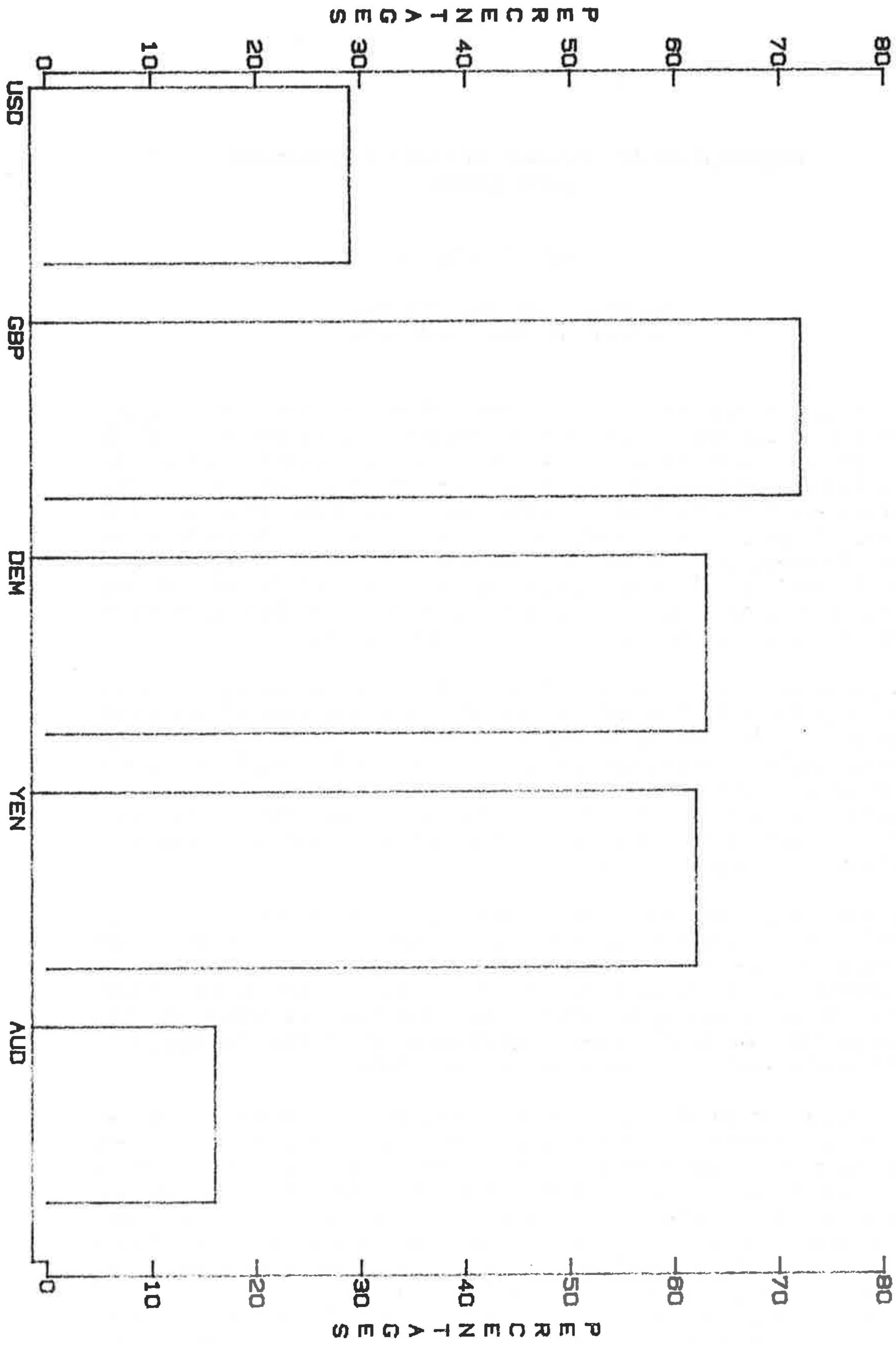
USA: 3 MONTH TREASURY BILLS
UK: INTER BANK STERLING RATE 3 MONTHS
WEST GERMANY: INTER BANK LENDING RATE 3 MONTHS
JAPAN: UNCONDITIONAL CALL MONEY
AUSTRALIA: 90 DAY BANK BILLS

SLIDE 2

CHANGE IN MAJOR CURRENCIES AGAINST AUSTRALIAN DOLLAR

1985





SLIDE 3

DEREGULATION OF DEALINGS IN FOREIGN CURRENCIES - LEGAL ISSUES

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In view of the limited time I won't deal with the introduction set out in the paper. While I am speaking I will ask for a slide to go on (see Appendix 1) which is my own humble effort to demonstrate the way in which our currency has weakened in the period since the Australian dollar was floated in 1983. You will find, in particular, that against Swiss francs, Deutsche marks and Japanese yen the depreciation has been quite staggering. I think that we all tend to concentrate on the US dollar and not look beyond that but clearly the depreciation of the Australian dollar against other currencies has been very significant.

My paper deals with two questions. The first is foreign currency accounts in Australia and the second is the question of awards of damages in Australian courts in foreign currencies and interest rates applicable to such judgments. I can deal with the first part of my paper in shorter time because, in point of fact, any successful deregulation tends to eliminate legal issues and there are few legal issues involved in the operation and maintenance of foreign currency accounts in Australia.

As part of the deregulation package announced by the Treasurer in 1983, the Treasurer stated that financial institutions are permitted to offer their clients and customers accounts denominated in foreign currencies. You will see in the paper that I do touch upon some of the anomalies involved in the exemptions and authorities granted pursuant to the Banking Act, 1959 and I won't deal with that at this time.

It might be helpful if I briefly indicate to you how a foreign currency account is operated in Australia. The procedure is set out on pages 3 and 4 of my paper. Typically a customer would go to his bank in Australia and instruct it to open an account denominated in a foreign currency. As far as the customer and bank are concerned, that account will be maintained in the books of the Australian branch of the bank. From the bank's point of view, it would usually be opening an account or already would have an account in the principal financial centre of that relevant currency and would, for its own internal accounting purposes, be posting all debits and credits conducted on the

customer's foreign currency account to that master account in New York, in the case of US dollars, London, in the case of sterling, Paris, in the case of French francs, and so on.

Perhaps, for the purposes of simplicity, I will restrict my examples to US dollar accounts. When interest falls due the interest could be paid either in New York to an account nominated by the customer, in US dollars, or, alternatively, an arrangement could be established with the bank providing for the bank to convert the US dollar amount of interest into Australian dollars at the prevailing rate of exchange and then credit or debit that to the customer's account in Australia. A similar arrangement would apply in respect of principal. Accordingly, in substance, the transaction between the bank and its customer is a transaction between two residents, largely performed in Australia.

I have in my paper dealt with four legal issues that might arise in relation to such accounts. The first is the foreign exchange control system which I think is adequately dealt with in my paper. The second is withholding tax. In essence as the transactions are resident transactions, there should be no scope for the imposition of Australian interest withholding tax, all the more so if interest is paid and received in Australia. If interest is paid and received outside Australia, attention may need to be given to section 128B(2A) of the Income Tax Assessment Act, 1936.

In the case of the bank's relationship with the Reserve Bank, it is interesting to note that quite a discussion is going on at the moment in relation to prudential supervision by the Reserve Bank and I am told that the Reserve Bank generally is not particularly concerned with the volume of foreign currency accounts which Australian banks operate. However, if those banks do not match their books on their exposure in respect of those accounts, any exposure will be included in the bank's general exposure for the purposes of determining their ratios and prudential requirements.

I think, just in passing, I would also like to mention that we cannot ignore the fact that the laws of foreign jurisdictions may be relevant. By way of example, on page 5 of my paper, I touch upon the potential application of the Income and Corporation Taxes Act, 1970 in the UK in the case of payments of interest in sterling. That Act can require banks to deduct an amount on account of taxes from interest paid in certain circumstances.

Perhaps the more interesting part of my paper is the second part dealing with awards of damages in foreign currencies, which commences on page 6. Until recently, Australian courts had declined to grant judgments in foreign currencies. I am sure all of us are aware that for some years in the UK English courts have been prepared to grant judgments in foreign currencies when they consider that is appropriate to do so. Quite an interesting extract appeared in the Modern Law Review back in 1978 (41 M.L.R. 1) where his Honour Mr Justice Kerr noted the profound change

which took place in the mid 1970s in the approach taken in English courts. The notable case of Miliangos v. George Frank (Textiles) Ltd. [1976] A.C. 443 comes to mind in which the House of Lords stated that English courts could give judgments in foreign currencies.

After that case, I believe that some States of Australia were prepared to award judgments in foreign currencies although the first reported decisions did not arise until 1983. In 1983 the Supreme Court of New South Wales in Mitsui Osk Lines Ltd. v. The Ship "Mineral Transporter" [1983] 2 NSWLR 564 gave a reported judgment in which they awarded a judgment in a foreign currency. The test which the Court applied was "which is the currency which most truly expresses the plaintiff's loss?"

An interesting feature of that decision was that the Court awarded interest from the date that damage was incurred up to the date of judgment based upon the Australian interest rate then prevailing. This, of course, was a doubtful basis for awarding interest and was later rejected in Group Sprinks Reinsurance Pools v. Ipec Holdings Limited [No. 1570 of 1983 NSW Sup. Ct., Common Law Division] and Maschinenfabrik Augsburg - Nuremburg Aktiengesellshaft v. Alktikar Pty. Ltd. [1984] 3 NSWLR 152. Another interesting aspect of the Group Sprinks case (which is an unreported case) is that judgment was awarded in that case in a combination of foreign currencies as it was felt by the court that those currencies best expressed the plaintiff's loss.

The Group Sprinks case could be of special interest to anyone who has to consider some of the difficult legal issues involved in ECU financial obligations, such as Eurobonds or loans denominated in ECU. From time to time we are called upon to opine on whether or not a judgment could be obtained in an Australian court expressed in ECU. I am sure that you are aware that ECU, being the Economic Currency Unit of the EEC, is probably not a currency as commonly understood by the courts; it represents a weighted basket of currencies of the member states of the EEC, and it is reviewed periodically (I believe once every five years).

The view that I have held and continue to hold is that an Australian court is unlikely to award a judgment in ECU on the basis that it is not a currency. The interesting aspect of the Groups Sprinks case is that it might leave open the opportunity for a court to award a judgment on the basis of the component currencies of ECU. This rather suggests that if you are concerned about these issues there might be some value in providing in your contract that the parties contemplate that their loss could be represented by the component currencies of ECU.

Returning to the question of interest rates, it is worth noting that in the Alktikar case the court considered at some length the question of what is the appropriate interest rate in determining the amount of damages in a foreign currency. It came to the conclusion that the interest rate obtaining in the relevant

currency should be the appropriate guide. Accordingly, if one was granting judgment in Deutsche marks one should look at the interest rates prevailing in Deutsche marks and work out the amount of interest to be included in the award of damages based upon those prevailing rates.

At the conclusion of my paper I have posed a number of questions which may arise in applying these principles in practice. It is very easy to rest content with the proposition that a court will award a judgment in foreign currency. Coping with the practical implications of that might be quite a difficult thing to do in practice. If a number of currencies are relevant to the litigation, how do you establish which currency best expresses the plaintiff's loss? If you obtain a judgment in foreign currency, how do you satisfy the judgment if you seek to attach the judgment to the assets of the defendant which are in Australia and which will be sold for Australian currency? Is there an opportunity for plaintiffs and defendants to abuse the rules? Could it be to a party's advantage to delay litigation or settlement based upon its assessment of prospective movements in exchange rates? Could this raise practical difficulties when considering the universal principle in all damages cases of mitigating one's loss? Can the new flexibility lead to a situation where uncertainty arises, a defendant in the knowledge that he will be sued might want to establish the currency in which he will be sued so that he can start preparing for the worst case?

APPENDIX 1

The following table represents the amount of foreign currency which could be purchased with one Australian dollar on 30th November, 1983 (prior to floatation of the Australian dollar) and the amount which could be purchased on 30th April, 1986.

Currency	Nov 1983	Apr 1986	Change
US$	0.9128	0.7365	-19%
Sterling	0.6266	0.4707	-25%
Swiss Franc	1.9806	1.3220	-33%
D Mark	2.4660	1.5851	-36%
Yen	213.73	122.45	-43%

Source: November, 1983 - Reserve Bank of Australia Bulletin; 30 April, 1986 - Australian Financial Review - 30 April, 1986.