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Bank Loan Denial for Nuclear Proliferation under Section 102(b) of the Arms Export Control Act as Applicable to India and Pakistan

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Summary

After the President has determined that a "non-nuclear-weapon state" has detonated a "nuclear explosive device," section 102(b) of the Arms Export Control Act requires that a number of sanctions be placed on that state including the prohibition of private bank loans to the government of the country concerned. When the President responded to the nuclear tests of India and Pakistan by invoking sanctions on May 13 and 28, immediate questions arose as to how the banking aspects of the sanctions would be configured. There is a strong U.S. banking presence in India involving many levels of interactions with Indian banking, trading, and development companies that are intertwined with the Indian government. This situation raises issues as to whether sanctions would extend to governmentally owned and controlled institutions. Section 102(b) has never before been invoked. Its language is sparse; and no regulations have been promulgated explicating its terms. The Department of the Treasury, in the process of evaluating the requirements of the law, faced pleas from the banking community to take into consideration the complex interrelationships of banking and government in India and Pakistan and proceed cautiously lest operations of U.S. bank branches in those countries be jeopardized. Using authority of the India-Pakistan Relief Act of 1998, P.L. 105-277, Tit.IX, § 901, enacted as part of the omnibus appropriations measure of October 19, 1998, the President has waived the India-Pakistan sanctions until October 21, 1999. For a description of the requirements of section 102(b), see Jeanne J.Grimmett, "Nuclear Sanctions: Section 102(b) of the Arms Export Control Act and Its Application to India and Pakistan, CRS Report 98-486. This report may be updated.

This report discusses one of the sanctions, denial of bank loans, under section 102(b) of the Arms Export Control Act (AECA), 22 U.S.C. § 2799aa-1(b), enacted in the Nuclear Proliferation Prevention Act of 1994. Section 102(b) requires the President to impose economic and military sanctions against countries that have engaged in certain kinds of

nuclear proliferation. After India, on May 11 and 13,¹ and Pakistan,² on May 28, detonated nuclear devices, President Clinton invoked sanctions against those countries.³ Among the sanctions are prohibitions on foreign assistance; sales and licenses under the AECA; U.S. government credits, credit guarantees, and financial assistance; U.S. support for multilateral financial assistance; private bank lending to the affected government; and exports of certain specific controlled goods and technology. On December 1, 1998, under Presidential determination No. 99-7, the sanctions were waived until October 21, 1999, pursuant to the India-Pakistan Relief Act of 1998, P.L. 105-277, Tit. IX, § 901.

U.S. Banking in India and Pakistan

U.S. commercial banking concerns, including Bank of America, Bank of New York, Chase Manhattan Bank, and Citibank have branch operations in India, conducting a full range of banking services for individual and corporate clients, supporting international trade and Indian domestic transactions. Although Federal Reserve Board approval must be secured before a U.S. bank may establish a foreign branch, the foreign branch operates under the laws of the host country and may engage in some activities that would not be permitted in the United States.⁴

The Indian government imposes certain requirements on banks operating within the country that make the process of drafting the sanction regulations a balancing exercise. What must be balanced is the need to actualize the intent of the legislation and the preservation of U.S. banking operations within India.

In order to obtain approval to operate a foreign bank branch in India, a U.S. bank must maintain cash deposits at the central bank, which is controlled by the state. It must also hold a 25% reserve ratio in Indian treasury bills or bonds of state-owned companies. In addition, since the state holds 51% ownership in each bank, correspondent banking

¹ See CRS Issue Brief 93097, *India-U.S. Relations*.

² See CRS Issue Brief 94041, *Pakistan-U.S. Relations*.

³ The India directive, Presidential Determination No. 98-22, 63 *Federal Register* 27665 (May 20, 1998), ordered the "relevant agencies and instrumentalities of the United States Government...to take the necessary steps to impose the sanctions described in section 102(b)." In addition to the Department of the Treasury, which will administer the banking sanctions in the Office of Foreign Assets Control, the Departments of State and Commerce have responsibility for administering the AECA and the Export Administration Act licensing systems. The Department of State has already issued a notice revoking munitions exports licenses for India, 63 *Federal Register* 27781 (May 20, 1998). On May 28, the Department of Commerce issued "Interim Guidance for Exporters. (See <www.BXA.DOC.GOV>.)

⁴ The Board has authority to authorize activities that it determines to be usual in connection with the business of banking in the host country. 12 C.F.R. § 211.3(b)(10). Among the powers authorized foreign banks that are pertinent to the question of application of the sanctions are some that appear to be essential to the operation of foreign bank branches in India. Under Federal Reserve Board regulations, a foreign branch may issue buy, sell, and hold the obligations of the host country's national government and its political subdivisions; invest in the securities of the host country's central bank and other securities needed to meet reserve requirements; and it may invest in government-sponsored development banks of its host country and in securities needed to meet reserve requirements. 12 C.F.R. § 211.3(b).

relations by which banks maintain deposits with one another to clear checks and other forms of negotiable instruments, may be routine between Indian state-owned banks and Indian branches of U.S. banks.⁵

The banking situation in Pakistan is distinguishable from that of India, although some of the same large banking organizations as are operating branches in India also have branches in Pakistan. Banks with Pakistani branches include Citibank, Chase Manhattan Bank, American Express Bank, and Bank of America. There are requirements similar to those in India. Pakistan requires 10% of demand and time liabilities be placed with the central bank, and banks must hold an additional 25% in government securities.⁶ On the other hand the central bank in Pakistan, the State Bank of Pakistan since 1993 is subject to reduced government control but is not completely autonomous. Until a new liberalized investment policy was announced in November 1997, Pakistan restricted foreign bank branching and business with state-owned corporations.⁷

Lack of Definitions in Section 102(b) Prohibition on Bank Loans

The language in section 102(b) respecting bank loans is unadorned.⁸ As recently amended, it reads:

The United States Government shall prohibit any United States bank from making any loan or providing any credit to the government of that country, except for loans or credits for the purpose of purchasing food or other agricultural commodities, which includes fertilizer.

Although this provision was enacted in 1994, Treasury has not issued any implementing regulations. It apparently has adopted a policy of waiting until the President invokes sanctions against a particular country to address each country's individual situation⁹ as is customary when economic sanctions are invoked under the

⁵ See Michael M. Phillips, "Banks Lobby Washington for Slack in Indian Sanctions," *Wall Street Journal* A-15 (May 22, 1998) and "Business Groups Face Uphill Battle in Effort to Limit Indian Sanctions," *Inside US Trade* (May 22, 1998). Krisan S. Nehra, Specialist in Indian and Pakistani Law, Library of Congress Law Library, was consulted on the material relating to legal requirements in India and Pakistan.

⁶ Department of the Treasury, *National Treatment Study* 06 (1994).

⁷ Federal Research Division, Library of Congress, *Pakistan: A Country Study* 161-165 (April 1994).

⁸ The legislative history has no further elaboration. See: 140 *Cong. Rec.* S411-S413 (daily ed. January 31, 1994); H.Rept. 103-482, 103d Cong. 2d Sess. 261-266(1994). The language specifically including fertilizer within the agricultural exception to the bank loan sanction was added by P. L. 105-194, enacted July 14, 1998. On July 15, the Senate approved by a voice vote an amendment to the FY1999 agriculture appropriations bill (S. 2159), which would authorize the President to waive certain of the sanctions, including the bank loan sanction. See S. Amdt. 3155, 144 *Cong. Rec.* S8183-85 (daily ed. July 15, 1998). On July 16, the Senate passed H.R. 4101, the FY1999 agricultural appropriations measure, inserting the language of S. 2159 for the text passed by the House. See 144 *Cong. Rec.* S8329 (daily ed. July 15, 1998).

⁹ In testimony before the House International Relations Committee June 3, 1998, Hearing (continued...)

International Emergency Economic Powers Act (IEEPA).¹⁰ In that case, after the President's order, Treasury issues regulations, to be administered by the Office of Foreign Assets Control. These regulations specifically apply the sanction to the institutional structure of the targeted country.¹¹

To illustrate the process by which an order is refined into regulations, one might examine the sanctions against Iraq. When, on August 9, 1990, President Bush invoked IEEPA to sanction Iraq, the directive, Executive Order 12724, generally prohibited "any commitment or transfer, direct or indirect, of funds or other financial or economic resources by any United States person to the Government of Iraq or any other person in Iraq."¹² The President, therefore, had decided to impose broad economic sanctions against not only the government of Iraq, but also any person in Iraq. This, of course, is distinguishable from the present situation where the law, itself, mandates a broad prohibition on bank loans to a "government."

The regulations implementing the Iraq sanctions, however, do illustrate the issues that the drafters of the India regulations will face. The Iraq regulations, issued on January 18, 1991,¹³ contained an intricate definition of the term "Government of Iraq," which, if applied to India, would mean closure for U.S. branches operating there. That definition was:

The term *Government of Iraq* includes:

- (a) The state and the Government of Iraq, as well as any political subdivision, agency, or instrumentality thereof, including the Central Bank of Iraq;
- (b) Any partnership, association, corporation, or other organization substantially owned or controlled by the foregoing;
- (c) Any person to the extent that such person is, or has been, or to the extent that there is reasonable cause to believe that such person is, or has been, since the effective date, acting or purporting to act directly or indirectly on behalf of any of the foregoing; and

⁹(...continued)

on Sanctions in U.S. Policy, Undersecretary of State Stuart Eizenstat referred to section 102(b) as "in some respects a very vague act." Many of the Committee Members were concerned about the impact on people in the United States and in the subject countries as well as on the deterrent effect. The Undersecretary referred to the process of drafting the regulations as involving mitigating the impact on U.S. business and workers.

¹⁰ 50 U.S.C. §§ 1701 - 1706.

¹¹ Under IEEPA, the President issues an Executive Order invoking the sanctions and delegates to the Department of the Treasury implementation authority, with respect to economic sanctions. At that point regulations are developed. This process may be lengthy. For example, it was not until May 21, 1998, that final rules were published implementing Executive Order 13047 of May 20, 1997, prohibiting new investment in Burma. 63 *Federal Register* 27846 (1998).

¹² 55 *Federal Register* 33091, 33092 (August 13, 1990).

¹³ 56 *Federal Register* 2113 (1991).

(d) Any other person or organization determined by the Director of the Office of Foreign Assets Control to be included within this section.¹⁴

Nowhere in section 102(b) is a definition given for the term "government," with respect to the country against which the sanctions are to operate. How broadly or narrowly that term is defined by the implementing regulations is critical. For example, will the state-controlled central bank be included in the definition? Will banks in which the state holds 51% equity be covered? How will state-controlled and owned development banks be handled? How will state-controlled corporations engaged in international trade be treated? Will Treasury distinguish between governmental entities acting or performing sovereign functions from government-owned or -controlled entities performing commercial functions? One approach that has been suggested is to limit sanctions to Indian or Pakistani governmental operations that are performing sovereign functions, rather than commercial or proprietary ones. The Foreign Sovereign Immunities Act, 28 U.S.C. §§ 1601 - 1611, by which foreign states are subject to U.S. court jurisdiction for commercial, but not governmental functions, may provide an analytical framework for making such distinctions.¹⁵

Section 102(b) does not define "United States bank." Does it mean only U.S. commercial banks or does it include development banks? Does it include branches of Indian banks operating in the United States? Does it include securities firms?

Section 102(b) does not define "making any loan or providing any credit to the government of [the sanctioned] country." How will Treasury treat the required investment in Republic of India currency and obligations imposed upon branches of U.S. banks doing business in India? How will it treat currency swaps involving Indian currency? What will be the treatment of sales and exchanges of securities that have already been issued by the Republic of India? What distinctions will be drawn with respect to banking transactions facilitating India's purchases of exempt commodities, such as food and agricultural products? What rules will apply to interbank loans, deposits, and clearing of negotiable instruments? Will there be exceptions for interbank clearances of checks and payment settlements that may result in overnight debit balances?

Section 102(b) does not designate an agency to enforce the bank loan sanctions. This raises the question of whether the Office of Foreign Assets Control at Treasury or the Federal Reserve Board will be designated with that authority. Arguments in favor of the

¹⁴ 31 C.F.R. §§ 575.306.

¹⁵ The Foreign Sovereign Immunities Act applies to foreign states and determines whether to differentiate an agency or instrumentality of the state as being subject to jurisdiction based on whether the core functions of that entity are governmental in nature. The statute has an exception by which jurisdiction is denied over suits "based upon a commercial activity carried on ... by the foreign state." 28 U.S.C. § 1605(a)(2). In *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992), the Supreme Court held Argentina subject to suit to recover on bonds, called Bonads, issued through its central bank, under a program whereby the government had assumed the risk associated with cross-border currency transactions. To reach the decision, the Court distinguished between a government as a market regulator and as a player in the market. The issuance of the bonds, of public debt instruments, was held to be a commercial activity and was seen to be similar to issuance of debt instruments by private parties.

latter include its familiarity with the banks involved and its distance from any presidential administration. There also may be the perception that Federal Reserve Board oversight would bring more flexibility.

Conclusion

Absent a mechanism in section 102(b) for terminating or suspending a sanction, legislation appears to be the only way of lifting sanctions, once imposed. In the case of the sanctions against India and Pakistan, under the Indian-Pakistan Relief Act of 1998, P. L. 105-277, Tit. IX, § 901, Congress authorized a Presidential waiver for a period of up to one year. The President used this authority to waive the sanctions until October 21, 1999.