

*University of New South Wales*  
University of New South Wales Faculty of Law Research Series  
2009

---

*Year 2009*

*Paper 18*

---

## The Role of Reputation in Banking

Ross P. Buckley\*

Justen Nixon†

\*University of New South Wales

†Solicitor of the Supreme Court of New South Wales

This working paper is hosted by The Berkeley Electronic Press (bepress) and may not be commercially reproduced without the permission of the copyright holder.

<http://law.bepress.com/unswwps-flrps09/art18>

Copyright ©2009 by the authors.

# The Role of Reputation in Banking

Ross P. Buckley and Justen Nixon

## **Abstract**

The law is the dominant framework within which transactions occur. However, another important framework is that of reputation and the need all businesses have to enhance and preserve it. Usually through long experience, legal practitioners become aware of the influence and importance of reputation, and the role that the need for any business to preserve it serves as an enforcement mechanism.

This essay considers the role of the institution of reputation in banking transactions, in particular the role of reputation in documentary credit transactions.

## The Role of Reputation in Banking

by

Ross P Buckley\* and Justen Nixon\*\*

### Introduction

The law is the dominant framework within which transactions occur. However, another important framework is that of reputation and the need all businesses have to enhance and preserve it.<sup>1</sup> Usually through long experience, legal practitioners become aware of the influence and importance of reputation, and the role that the need for any business to preserve it serves as an enforcement mechanism.

This essay considers the role of the institution of reputation in banking transactions, in particular the role of reputation in documentary credit transactions. The essay is in two parts.

The first part begins by examining the concept of reputation, and its role in contemporary banking. It then analyses two historical examples: the success of the Knights Templar as bankers in the 12<sup>th</sup> and 13<sup>th</sup> centuries, and of the Mahgribis as traders in the 11<sup>th</sup> century. These studies illumine the importance of reputation as an informal enforcement mechanism in situations where formal (or legal) institutions fail to enforce rights, or do so inefficiently.<sup>2</sup> The Knights Templar operated Europe's leading banking business and regularly facilitated international credit transactions.<sup>3</sup> We examine their reputation for administrative capacity and integrity and the role it played in the Order carrying out its banking functions.<sup>4</sup>

The essay then briefly considers what game theory predicts about the role of reputation.

---

\* B.Econ., LL.B. (Hons), Ph.D., LL.D., Professor of Law, University of New South Wales; Senior Fellow, Tim Fischer Centre for Global Trade & Finance, Bond University.

\*\* BA, LL.B., Solicitor of the Supreme Court of New South Wales.

<sup>1</sup> Avner Greif, 'The fundamental problem of exchange: A research agenda in Historical Institutional Analysis' (2000) 4 *European Review of Economic History* 251, 251 'In a modern economy a host of inter-related institutional features mitigate this fundamental problem of exchange (FPOE), thereby enabling exchange to take place. Institutions structure our relationships in a manner that enables us to benefit from transacting.'

<sup>2</sup> Avner Greif, 'Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition' (1993) *The American Economic Review* 526, 529.

<sup>3</sup> Eleanor Ferris 'The Financial Relations of the Knights Templars to the English Crown' (1902) 8(1) *The American Historical Review* 1, 1.

<sup>4</sup> Ferris, id at 17.

The second part of the essay examines the role of reputation in letter of credit transactions specifically. Payment by letter of credit allows parties to an international business transaction to overcome the fundamental problem of exchange – that fact the seller may otherwise have to part with possession of the goods before receiving payment or the buyer part with their money before receiving the goods. A letter of credit arrangement involves the replacement of the promise of an unknown and potentially unreliable party with the promise of a reputable bank.<sup>5</sup> A high proportion of documentary presentations under credits contain errors that justify the applicant in avoiding the obligation to pay under the credit. Yet the great majority of these errors are waived and not relied upon. The reason for this may be that banks may select with considerable care the customers to which they will grant letter of credit facilities, because banks may be keen to avoid the negative effects on their reputation of being seen to insist on minor technical deficiencies in the tendered documents as grounds upon which not to pay. The essay examines the thesis that this careful selection process is the critical reason credits are reliable and trusted in practice.<sup>6</sup>

## **Part I – The Institution of Reputation**

### **What is reputation?**

Reputation can be defined simply as ‘what is generally said or believed about a person’s or thing’s character’.<sup>7</sup> Reputation has a social element. Maintaining a good reputation and being able to find someone to vouch for your good character remain an important part of modern life. Reputation, although intangible and difficult to quantify, plays a crucial role in social, professional and commercial interactions.<sup>8</sup>

Reputation can be built through constant adherence to a mode of conduct or through the advertisement of particular qualities. Reputation need not have any correlation to actual past performance, although often it does.

In commercial transactions, parties may have an established history of dealings which leads each to form views of the others’ character. This continuing relationship may result in the establishment of trust,<sup>9</sup> or an understanding between the parties, with each being able to rely on the other party to do what is necessary to ensure the success of the transactions.<sup>10</sup>

---

<sup>5</sup> Ronald J. Mann, ‘The Role of Letters of Credit in Payment Transactions’ (2000) 98 (8) *Michigan Law Review - Symposium: Empirical Research in Commercial Transactions* 2494, 2495.

<sup>6</sup> Mann, id at 2521.

<sup>7</sup> F.G. Fowler and H. W. Fowler, *The Pocket Oxford Dictionary* (4<sup>th</sup> ed, 1967) 690.

<sup>8</sup> Consider individuals applying to be admitted as a lawyer in the Supreme Court of NSW, who are required to provide two character references that specifically mention the applicant’s honesty and integrity (Form 3). Legal Profession Admission Board, available at <<http://www.lawlink.nsw.gov.au/lpab>> 21 June 2008.

<sup>9</sup> Avner Greif, ‘Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders’ (1989) 49(4) *The Journal of Economic History* 857, 864.

<sup>10</sup> Mann, above n 5, 2514.

## Reputation in banking

### *Reputation in contemporary banking*

It is axiomatic that reputation matters in banking. People need to trust those with whom they deposit money. Research suggests banks are particularly sensitive to reputation risk,<sup>11</sup> and that decisions made by banks ‘reflect reputational concerns’.<sup>12</sup> Reputation also influences the types of relationships that banks will maintain with their customers, and the cost the bank is willing to incur to maintain those relationships.<sup>13</sup>

Fang argues that a good reputation enhances the effectiveness of an investment bank as a financial intermediary.<sup>14</sup> Empirical research by Fang found that entities issuing corporate bonds received better financial rewards if these securities were underwritten by a reputable investment bank.<sup>15</sup> A review of the data also found that banks were selective about which bonds they underwrite, and, to safeguard reputation, banks will not underwrite bonds which were likely to perform poorly.<sup>16</sup> Fang argued that a good reputation adds value for the client, by acting as a certification mechanism for the quality of securities offered by the bank.<sup>17</sup> Fang concludes:

Overall, the findings suggest that banks’ underwriting decisions reflect reputation concerns, and thus are informative of issue quality. Investors infer a positive signal when a reputable underwriter agrees to put his name on the line, and *ceteris paribus*, the market clears at a higher price for the issuer.<sup>18</sup>

In support of the reliability of this signal, Fang notes that investment banks ‘are repeated players in the financial markets, and as such, their survival and future income is directly tied to their reputation.’<sup>19</sup> The need to preserve reputation should deter banks from opportunistic behaviour that will derive short term gains ‘at the cost of losing reputation and future income’.<sup>20</sup>

---

<sup>11</sup> K. Thomas Liaw, *The Business of Investment Banking* (2nd ed, 2006) 36.

<sup>12</sup> Lily Hua Fang, ‘Investment Bank Reputation and the Price and Quality of Underwriting Services’ (2005) 6 *The Journal of Finance* 2729, 2730 and 2743.

<sup>13</sup> Fang, *id* at 2752, and I Serdar Dinc, ‘Bank Reputation, Bank Commitment, and the Effects of Competition in Credit Markets’ (2000) 13(3) *The Review of Financial Studies* 781.

<sup>14</sup> Fang, *id* at 2731.

<sup>15</sup> Fang, *id* at 2730 and 2735. For the purpose of the study Fang classifies the top eight banks by market share as “reputable”. Fang examined ‘[d]ata on corporate nonconvertible bonds issued between January 1, 1991 and December 31, 2000’.

<sup>16</sup> Fang, *id* at 2755.

<sup>17</sup> Fang, *id* at 2756 and 2759.

<sup>18</sup> Fang, *id* at 2730.

<sup>19</sup> Fang, *id* at 2730 and 2756.

<sup>20</sup> Fang, *id* at 2730. Also, De Long, J. Bradford, ‘Did J. P. Morgan’s men add value?: An economist’s perspective on financial capitalism’ in Peter Temin (ed), *Inside the Business Enterprise: Historical Perspectives on the Use of Information* (1991), quoted in Fang, *id* at 2734. As long term market participants, banks will not “cash in” reputation by luring investors into a profitable deal...[i.e profitable for the bank]...that is unsound...[for the

In a credit market with increased competition, reputation will influence the banks' ability to attract borrowers.<sup>21</sup> Dinc argues that if a bank fails to meet lending commitments, it risks losing reputation, and borrowers will respond by approaching the bank's competitors for loans.<sup>22</sup> Considering this, Dinc argues that 'a bank's concern to maintain a "good" reputation can induce the bank to keep its commitment to a costly action'.<sup>23</sup>

Thomson and Jain argue that to successfully attract depositors and investors and to maintain share price, banks need to maintain a reputation for good corporate governance and regulatory compliance.<sup>24</sup> They cite, for example, the repercussions for the National Australia Bank (NAB) when it announced losses of \$360 million associated with the rogue trader scandal.<sup>25</sup> The NAB came under the close scrutiny of APRA, and Thomson and Jain argue, uncontroversially, that there was a direct link between the foreign currency scandal and the fall in the NAB share price (particularly, we would add, with this scandal following the \$4 billion of writedowns occasioned by the Homeside mortgage lending debacle in the U.S.).<sup>26</sup>

A McKinsey survey in 2002<sup>27</sup> found that a company's corporate governance had many consequences. Specifically, the survey found:

- 63% of investors would avoid companies with poor corporate governance,
- 57% would change their holdings as a result of poor corporate governance,
- 31% would avoid investing in countries known for poor governance practice and regulation,
- 28% would change their holdings in some countries if their governance practices varied, and
- 73-78% would pay a premium for a well governed company.

Thomson and Jain argue that a bank's reputation for good corporate governance will play a role in determining the cost of acquiring capital, and therefore profits.<sup>28</sup> We go

---

investors]...'. See also discussion below, under heading - *Reputation as a measure of risk – Game Theory*.

<sup>21</sup> I. Serdar Dinc, 'Bank Reputation, Bank Commitment, and the Effects of Competition in Credit Markets' (2000) 13(3) *The Review of Financial Studies* 781, 800.

<sup>22</sup> Dinc, id at 788.

<sup>23</sup> Dinc, id at 781 and 788.

<sup>24</sup> Dianne Thomson and Ameeta Jain, 'Corporate Governance Failure And Its Impact On National Australia Bank's Performance' (2006) 2(1) *Journal of Business Case Studies* 41, 50.

<sup>25</sup> Thomson and Jain, id at 48.

<sup>26</sup> Thomson and Jain, id at 50.

<sup>27</sup> Thomson and Jain, id at 50. The survey was titled "USA Global Investor Opinion Survey on Corporate Governance" (2002).

<sup>28</sup> The business of banking can be explained using a basic model. The bank acquires capital at a cost of A, and lends it at a cost of B. The profit for the bank (or margin) is B - A. Thomson and Jain, id at 50. 'Good corporate governance practices are increasingly important in determining the cost of capital in a global capital market. Australian companies must be equipped to compete globally and to maintain and promote investor confidence both in Australia and overseas.'

further and argue that for a bank the cost of capital is a function of reputation as a whole, and that bank profitability is therefore directly linked to bank reputation.

Through extensive corporate branding and advertising, banks seek to build an image of long term stability and good corporate citizenship. It is interesting to review what banks say about themselves.<sup>29</sup> A review of the Westpac website found this information:<sup>30</sup>

- ‘Committed to the environment.’
- ‘The first Australian bank to commit to the Equator Principles’.<sup>31</sup>
- ‘Westpac employees donate \$1m to charity. This amount was then matched dollar for dollar by the bank as part of our Matching Gifts program’.
- ‘Active in the community - Read our 2007 Community Involvement Report.’
- ‘China Earthquake appeal - Westpac launches Oxfam’s China Earthquake appeal with \$100k donation.’
- ‘Westpac Banking Corporation has a long and proud history as Australia’s first and oldest bank. It was established in 1817’.<sup>32</sup>

This information does not appear to have a direct connection to banking services offered by the bank. Instead, all of this information appears to be on the website to promote the reputation of the bank.<sup>33</sup>

This link between reputation as a whole and profit is a significant explanation for:

- the banking sector’s sensitivity to reputation, and
- the effectiveness of bank reputation as an enforcement mechanism.<sup>34</sup>

### ***Some banking history – The Knights Templar as bankers***

The Poor Fellow-Soldiers of Christ and of the Temple of Solomon, more commonly known as the Knights Templar, were one of the earliest European providers of banking and financial services. An examination of the military exploits of the

---

<sup>29</sup> We have specifically mentioned Westpac, but a review of the Commonwealth Bank, ANZ and Macquarie Group websites found similar content.

<sup>30</sup> Westpac (Page titled “Westpac Info”)  
<<http://www.westpac.com.au/internet/publish.nsf/Content/WI+HomePage>> 22 June 2008

<sup>31</sup> The Equator Principles are implemented through ‘processes that ensure that projects are developed in a socially responsible manner, according to sound environmental management practices’. Westpac (Page titled “Policy and governance”).  
<<http://www.westpac.com.au/internet/publish.nsf/Content/WICREV+Equator+principles>> 22 June 2008.

<sup>32</sup> Westpac (Page titled “Our Proud History”).  
<<http://www.westpac.com.au/internet/publish.nsf/Content/WICP+Our+proud+history>> 22 June 2008.

<sup>33</sup> Hayagreeva Rao, ‘The Social Construction of Reputation: Certification Contests, Legitimation, and the Survival of Organizations in the American Automobile Industry: 1895-1912’ (1994) 15 *Strategic Management Journal* 29, 31.

<sup>34</sup> Dinc, above n 22, 781.

Templars is beyond the scope of this article, however the financial services offered by the Templars to merchants, monarchs and others are of interest. Indeed, the factors that made the Knights Templar successful bankers in the 12<sup>th</sup> and 13<sup>th</sup> centuries continue to underpin the success of modern banking. The Knights Templar had a reputation for:

- financial skill, honesty and accuracy,
- the capacity to raise capital, and
- the capacity to securely maintain funds trusted to their care.<sup>35</sup>

This reputation was backed by the Order's administrative capacity and integrity.<sup>36</sup> The administrative processes of the Knights Templar and their emphasis on integrity were essentially an early form of corporate governance.

The Knights Templar are remembered for utilising debt and credit instruments in a way not previously seen in medieval Europe. In the words of Ferris:

In the unwarlike atmosphere of the counting-room, the soldiers of the Temple, for over a century, handled much of the capital of western Europe, becoming expert accountants, judicious administrators, and pioneers in that development of credit and its instruments, which was destined to revolutionise the methods of commerce and finance.<sup>37</sup>

The Templars often held funds deposited by a range of individuals who possessed valuables, including the Kings of England. As Ferris notes, the 'houses of the Templars possessed the great practical advantages of having been built by men who were excellent engineers and of being defended by the bravest soldiers of the age.'<sup>38</sup> Furthermore, as a religious order, the Knights Templar were not bound by national borders.<sup>39</sup> Templar strongholds were established across Europe and the Middle East, from England and Scotland to Armenia and Jerusalem.<sup>40</sup> This international presence gave the Templars the capacity to provide payment services in the nature of a bill of exchange.<sup>41</sup> The Templars' systems enabled payments to be made between London and continental Europe without the movement of cash. For instance, the Templars enabled Henry III to repay in London lenders in Florence from whom he had borrowed funds, and to pay in London for a ship purchased in Spain.<sup>42</sup>

---

<sup>35</sup> Ferris, above n 3, 2 and 6.

<sup>36</sup> Ferris, id at 17.

<sup>37</sup> Ferris, id at 1.

<sup>38</sup> Ferris, id at 4. Ferris also relates, at 6, that Templars assisted with the collection of English taxes levied on moveable property, and the auditing of royal accounts.

<sup>39</sup> Barbara Frale, 'The Chinon chart Papal absolution to the last Templar, Master Jacques de Molay' (2004) 30 *Journal of Medieval History* 109, 112 'As a religious order, the Templars were not under the king's jurisdiction and since the reign of Pope Innocent II had enjoyed some special privileges'

<sup>40</sup> Frale, id at 114.

<sup>41</sup> Ferris, above n 3, 12.

<sup>42</sup> Ibid.

The various Templar chapter houses would also advance sums secured against deposits held at other Templar locations. For instance, King Edward I relied on the Templars to advance sums in the Middle East to cover the costs of crusading in the Holy Land, thereby removing the need to physically carry valuables with him on the journey.<sup>43</sup>

The commercial transactions of the Knights Templar were possible because the contracting parties were able to place their trust in the Templars to carry through on their promises. The Order's reputation for integrity and administrative processes limited the risk facing potential clients.<sup>44</sup>

As a crusading military order at the height of a period of revived religious feeling, the Templars enjoyed a favourable position in society that influenced the way merchants and others interacted with them. In Frale's words, in 'the 12th century, the order went through a period of rapid growth, receiving donations from the papacy, kings, and lay men and women who wanted to be associated with the spiritual glory of the Templars.'<sup>45</sup> Also, the nature of the Templar organisation in that time, and their military capacities, placed them in a unique position to facilitate and enforce international transactions.

The historical record strongly suggests that the Templars had an outstanding reputation that strongly supported their banking business: '[k]eeping an iron discipline and enjoying a reputation of unblemished honesty, they became appreciated bankers and even ambassadors, used by popes and kings for financial transactions and political missions'.<sup>46</sup>

### **Reputation as an enforcement mechanism – The Maghribi Traders**

Avner Greif has built his career as a Stanford Professor of Economics by analysing the role of reputation amongst 11<sup>th</sup> century Mediterranean traders.<sup>47</sup> The Maghribi traders:

were a distinct group of Jewish traders from the 'Muslim West' – northern Africa west of Egypt, together with Muslim Sicily and Spain – who by the eleventh century were trading throughout the Muslim Mediterranean, from Iberia to Constantinople.<sup>48</sup>

The Maghribis faced the problem of trading across distances.<sup>49</sup> Greif notes that a trader 'could either travel along with his merchandise between trade centers or hire

---

<sup>43</sup> Feris, id at 8 and 10. Ferris notes that in the case of the English King a promise to pay was often sufficient security.

<sup>44</sup> Feris, id at 4, 3, and Greif, above n 9, 864 and 867.

<sup>45</sup> Frale, above n 40, 114.

<sup>46</sup> Ibid (At least until the controversy surrounding their decline and fall in the early 14<sup>th</sup> Century).

<sup>47</sup> Greif, above n 2, 526.

<sup>48</sup> Jeremy Edwards and Sheilagh Ogilvie, 'Contract Enforcement, Institutions and Social Capital: the Maghribi Traders Reappraised' (CESIFO Working Paper No 2254, March 2008)

1.

<sup>49</sup> Greif, above n 2, 526.

overseas agents to supply the service'.<sup>50</sup> Both options were problematic. If the merchant travelled with his goods, he lost the opportunity to enter into other transactions, and would have to spend a long time at sea, out of contact with the commercial world.<sup>51</sup> Hiring an agent raised other concerns. Greif argues that, '[w]ithout supporting institutions agency relations are not likely to be established since the agents can act opportunistically and embezzle the merchant's goods' and '[t]he evidence suggests that the coalition was a response to problems of contract enforceability'.<sup>52</sup>

Supporting institutions could have been a legal system, or other formal government agencies that would have imposed sanctions on proscribed opportunistic behaviour (such as embezzlement) and enforced rights.<sup>53</sup> Greif argues that in the 11<sup>th</sup> century the 'legal system failed to provide a framework within which agency relations could be organized'.<sup>54</sup> But even today, the rights of redress conferred by the law may be slow and costly to access and offer only uncertain outcomes.<sup>55</sup> Furthermore, there may be significant barriers to accessing a legal system in another jurisdiction.<sup>56</sup>

In response to the uncertainty of rights enforcement by formal institutions, Greif argues that the Maghribi traders organised a coalition to enforce agency contracts.<sup>57</sup> The coalition relied on traders operating simultaneously as merchants and agents for other traders,<sup>58</sup> and 'did not expand to include other merchants outside the Maghribi community'.<sup>59</sup> Contracts were enforced by a reputation mechanism which required an agent to deal honestly or risk being black listed by the coalition. Greif cites the following example:

Around 1055 it became known in Fustat that Abun ben Zedaka, an agent who lived in Jerusalem, embezzled the money of a Maghribi trader. The response of the Maghribi traders was to cease any

---

<sup>50</sup> Ibid.

<sup>51</sup> Greif, id at 528.

<sup>52</sup> Greif, id at 526 for the first part of the quotation and 544 for the latter part.

<sup>53</sup> Greif, id at 529. As to the role of government agencies consider research by Edwards and Ogilvie, above n 49, 9 and 10.

<sup>54</sup> Greif, above n 9, 866. Interestingly, Edwards and Ogilvie argue that the law was more developed than Greif's research suggests, even citing evidence of cross cultural co-operation between the Jewish and Muslim authorities. Edwards and Ogilvie, above n 49, 9 and 10.

<sup>55</sup> Greif, above n 2, 529.

<sup>56</sup> Avery Wiener Katz, 'Informality as a Bilateral Assurance Mechanism: Comments on Ronald Mann's "The Role of Letters of Credit in Payment Transactions"' (2000) 98 (8) *Michigan Law Review - Symposium: Empirical Research in Commercial Transactions* 2556, 2556.

<sup>57</sup> Greif, above n 9, 866. 'Organization theory predicts that when cooperation leads to efficiency gains which the market and the legal system fail to capture, "private order" economic institutions will be established.'

<sup>58</sup> Greif, above n 3, 539. 'The social structure of the Maghribi traders' group was "horizontal," as traders functioned as agents and merchants at the same time.'

<sup>59</sup> Ibid.

commercial relations with him. His bitter letter indicates that merchants as far away as Sicily had ostracized him.<sup>60</sup>

Another incentive for agents to deal honestly was ‘if an agent who had been accused of cheating were to receive agency services from other Maghribi traders, they could cheat him free from community retaliation.’<sup>61</sup>

The economic cost of being removed from a profitable coalition, and the risk of being cheated in turn by your agents, provided a strong incentive not to engage in opportunistic behaviour. The present value of dishonest conduct was likely to be substantially less than the future reward of remaining in the coalition.<sup>62</sup>

The case of the Mahgribi traders coalition was used by Greif to argue that that reputation can be an effective enforcement mechanism, especially in circumstances where formal institutions cannot, or will not efficiently, enforce rights.<sup>63</sup> For the Mahgribis the reputation mechanism worked in conjunction with economic sanctions. Greif’s research does not suggest that the threat of losing reputation by itself was sufficient to enforce behaviour.

Avner Greif’s work has been very widely cited. It is cited to support the view that in the absence of formal institutions close, complex social networks can generate enforcement mechanisms based on reputation, and that these private contractual enforcement mechanisms can substitute for a formal legal system and thereby support economic development.<sup>64</sup>

Indeed, the World Bank began Chapter One of its 2002 World Development Report, which was entitled *Building Institutions for Markets*,<sup>65</sup> with a description of the Mahgribi’s coalition drawn from Greif’s research. The Bank holds these concepts up as being important for the development of poor countries.

Douglas C North, the 1993 Nobel Laureate in Economics, and father of the field of institutional economics, often refers to Greif’s research as an example of other sorts of institutions, apart from courts and the rule of law, that can support economic growth.<sup>66</sup>

Douglas North’s research should be required reading for all lawyers. It makes clear how central the rule of law and other legal institutions are to economic growth. Businesspeople often see lawyers as getting in the way of doing deals. Anecdotally, in-house counsel often relate their frustrations at being seen as a cost-centre, not a

---

<sup>60</sup> Greif, id at 530.

<sup>61</sup> Greif, id at 531.

<sup>62</sup> Greif, above n 9, 881.

<sup>63</sup> Katz, above n 57, 2556.

<sup>64</sup> Karen Clay, ‘Trade without Law: Private-Order Institutions in Mexican California’ (1997) 13 (1) *Journal of Law, economics and organization* 202, 203 and 207-208; John McMillan and Christopher Woodruff, ‘Private Order under Dysfunctional Public Order’ (2000) 98 *Michigan Law Review* 2421, 2433-35 and Gerald O’Driscoll and Lee Hoskins, ‘The Case for Market-Based Regulation’ (2006) 26 *The Cato Journal* 469, 476.

<sup>65</sup> World Bank, *2002 World Development Report: Building Institutions for Markets*, (2001) 3.

<sup>66</sup> Douglas C North, lecture at Chicago-Kent School of Law, Chicago, October, 1999, attended by lead author.

productive unit of the business. North's work is the perfect antidote to the ennui that at one time or another seems to afflict many practising lawyers. North's research proves that for an economy to flourish it needs strong legal institutions to ensure property rights, contractual enforcement and incentives for effort. To read him is to become convinced that commercial lawyers do, indeed, play an essential role in a modern economy.<sup>67</sup>

There seems no reason to doubt North's insights. They accord with individual experience and the historical development of countries.

However, in early 2008 a paper was published which utterly refutes the empirical basis of Avner Greif's work. Jeremy Edwards and Sheilagh Ogilvie<sup>68</sup> argue that:

Greif's view of the Mahgribis' institutions and economic behaviour is untenable. Second, the Mahgribis cannot be used to advocate exclusive, private-order social networks to enforce contracts and facilitate exchange in developing countries. Third, the Mahgribis do not provide any foundation for a "cultural" theory of development.

Not a single empirical example adduced by Greif shows that any "coalition" actually existed. The examples he presents show the Maghribis using the formal legal system, supported by informal pressures based on reputation and repeated transactions between the same parties, as in any commercial economy.<sup>69</sup>

At the time of writing, the battle of ideas was full-fledged. Avner Greif had responded in no uncertain terms, arguing that Edwards and Ogilvie's 'claim that the relations of merchants with their overseas agents were law-based is wrong.'<sup>70</sup>

Who is right doesn't much matter to us for this paper's purpose. Reputation is clearly important to banks, who are, in many ways, consummate repeat players in nearly all the markets in which they operate.

This battle of ideas viewed for its own sake, is another matter – it is fascinating. Edwards and Ogilvie, from Cambridge, are arguing for the importance of a formal rule of law and legal institutions and against the idea that culture fuels development. Greif, from Stanford, is arguing that the Mahgribis achieved contractual enforcement and property rights through social interaction, which was a product of their collectivist culture. Greif contrasts the allegedly collectivist Mahgribis with the individualistic, law-based approach of the Genoese and emphasises how, over time, the Genoese came to control Mediterranean trade and the Mahgribis went into decline.<sup>71</sup>

---

<sup>67</sup> DC North, *Structure and Change in Economic History* (1981); and DC North, *Institutions, Institutional Change and Economic Performance* (1990).

<sup>68</sup> Edwards and Ogilvie, above n 49, 1.

<sup>69</sup> Edwards and Ogilvie, id at 43.

<sup>70</sup> Greif, Avner, 'Contract Enforcement and Institutions Among the Maghribi Traders: Refuting Edwards and Ogilvie' (July 1, 2008), 1. Available at SSRN: <[http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=46771](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=46771)> 20 August 2008.

<sup>71</sup> Edwards and Ogilvie, above n 49, 38.

Greif thus finds evidence in this period of history for the superiority of the contemporary Western individualistic, rights-based approach to law and economics over the collectivist cultures that tend to predominate in developing countries. Edwards and Ogilvie refute these conclusions, and the empirical basis for them, alleging that the Mahgribis ‘made extensive use of the legal system to register the basis upon which their long-distance trade ventures were undertaken, and took disputes concerning their business associations before courts of law’.<sup>72</sup>

What we have here, in a sense, is the mirror-image of the Asian Values debate of the 1990s. In Asia in the early 1990s, until the Asian economic crisis of 1997, it became popular to speak of “Asian Values”. A definition of these values was never settled upon, to the best of our knowledge, but in broad terms Asian Values were seen to prioritise cooperation over competition and value collectivist cultures over individualistic ones. Asian Values was a popular idea, particularly in Singapore and Malaysia, as it was promoted by Lee Kuan Yew and served as a bridge to link the values of Chinese, Muslim and indigenous peoples in the region. Asian Values were also used to explain the long economic surge by the Asian Tiger economies. The suggestion was that the crises that usually follow booms in capitalism did not need to be repeated in Asia, because it was different. Asia was alleged to operate on different values that better sustained economic growth, at least until mid-1997.

Amartya Sen, another Nobel Laureate in Economics, and a generally luminous intellect, has taken severe issue with the concept of Asian Values, in particular because the idea was used to support authoritarianism as a system suited to Asia.<sup>73</sup> Asian Values, as a concept, hasn’t withstood the test of time, and Sen’s devastating critique is convincing.

In analysing the experiences of the Mahgribis and extrapolating from it to the suitability of contemporary cultures to support economic development, we have an implicit argument for American values. While the Asian Values debate was highly controversial in the 1990s, the U.S. assumption that individualistic, rights-based approaches are best for economic growth often passes with little scrutiny.

What is clear to us, is that Avner Greif has seen what he has in the Mahgribi’s experience because of the cultural prism through which he is viewing it.

### **Reputation as a measure of risk – Game Theory**

Game theory aims to explain interactions between participants in a game, based on players making rational choices to achieve the highest personal reward.<sup>74</sup>

Game theory models establish that in games involving repeated transactions, a player’s present behaviour will be driven by expectation of future reward, that is, the possibility of entering into profitable transactions in the future.<sup>75</sup> They will be less

---

<sup>72</sup> Edwards and Ogilvie, id at 39.

<sup>73</sup> Amartya Sen, ‘Human Rights and Asian Values: What Lee Kuan Yew and Le Peng don’t understand about Asia’ (1997) 217 *The New Republic*.

<sup>74</sup> Eric Rasmusen, *Games and Information – An introduction to Game Theory* (4th Ed, 2005) 2.

<sup>75</sup> Avner Greif, above n 2, 530, 531 and 532. These models were developed to support his conclusions about the operation of a reputation mechanism in the Maghribi Traders coalition.

likely to enter into opportunistic behaviour and cheat, because the value of future reward is greater than any present value gained from cheating.<sup>76</sup>

The models show that the risk of an adverse outcome is increased if there is no prospect of a future transaction between the parties. This is because the need to maintain reputation is removed.<sup>77</sup> In Greif's words, in 'an anonymous market, conduct in a given period has no effect upon the reward in subsequent periods.' Accordingly, the theory suggests that when reputation is not an element, i.e. in single, anonymous interactions, there is a greater risk that a player will be subjected to opportunistic behaviour.<sup>78</sup>

### **The need to preserve reputation as a driver of behaviour**

Generally in cross border transactions a party may have only limited recourse to established legal frameworks to enforce rights. In these circumstances, informal institutions such as reputation may become an efficient mechanism for enforcing behaviour.<sup>79</sup>

The conclusions of game theory and the organisation of the Maghribi traders are directly relevant today. Both establish that reputation will impact on the behaviour of parties.

Game Theory models demonstrate that a need to maintain reputation for future transactions will strongly influence behaviour in the current transaction.<sup>80</sup> Greif's perspective on the Maghribi coalition provides an historic example of factors ensuring contract enforcement outside of a legal framework.

By examining game theory models and Greif's perspective on contract enforcement by the Maghribis, it can be argued that reputation in business transactions will be:

- an indicator of the likelihood of opportunistic behaviour by a party,
- a driver of behaviour across repeated transactions, and
- a mechanism that will enforce obligations without the need to have recourse to formal institutions.<sup>81</sup>

As part of the business risk evaluation process, reputation should be an issue that is considered at the threshold of a transaction. However, it may not be possible to make enquiries about the other party that will yield useful information. Moreover, in Mann's words, 'the sheer number of potential trading partners worldwide makes the task of maintaining any knowledge of financial strength and probity daunting at best.'<sup>82</sup> In order to access new markets and enter into profitable exchanges, businesses

---

<sup>76</sup> Greif, above n 9, 881.

<sup>77</sup> Greif, id at 865.

<sup>78</sup> Ibid.

<sup>79</sup> Greif, above n 2, 526.

<sup>80</sup> Greif, id at 533.

<sup>81</sup> Greif, above n 1, 252.

<sup>82</sup> Mann, above n 5, 2522.

will have to enter into transactions with parties with which they don't have established relationships.<sup>83</sup>

## **Part II – Reputation and Letters of Credit**

### **The role of reputation in enhancing the efficacy of letters of credit**

Unless goods and payment are exchanged simultaneously, there is a risk that parties to an exchange may not fulfil their obligations.<sup>84</sup> Edwards explains that '[t]he seller may take the payment and not give the good, or the buyer take the good and not give the payment'.<sup>85</sup> Avner Greif calls this the "fundamental problem of exchange".<sup>86</sup> The Greif – Edwards and Ogilvie battle is about whether the Mahgribis resolved this problem primarily by using a coalition of agents whose behaviour was regulated by concern for their reputation and the threat of societally enforced sanctions such as exclusion from the coalition (Greif's view), or primarily by recourse to laws and courts (Edwards and Ogilvie's view).

Letters of credit are one of the primary ways we resolve the fundamental problem of exchange today, and have resolved it for centuries. In the words of Lord Diplock,

the whole commercial purpose for which the system of confirmed irrevocable documentary credits has been developed in international trade is to give to the seller an assured right to be paid before he parts with control of the goods.<sup>87</sup>

Letters of credit are a mercantile specialty, a device developed by merchants to which the courts later gave effect, even though they don't fit neatly into the law's concept of a contract.

In a basic letter of credit transaction there will be three parties: the applicant, the issuer and the beneficiary.<sup>88</sup> The applicant is generally the party purchasing goods, the issuer is a bank of good reputation, and the beneficiary is the seller of goods. At the request of the applicant, the bank will issue a letter of credit, in which it promises to pay the beneficiary upon the presentation of certain documents specified in the letter of credit.<sup>89</sup>

Letters of credit transactions are governed by two fundamental principles:

- the principle of independence, and

---

<sup>83</sup> Greif, above n 1, 253.

<sup>84</sup> Edwards and Ogilvie, above n 49, 5.

<sup>85</sup> Ibid.

<sup>86</sup> Greif, above n 1, 251.

<sup>87</sup> *United City Merchants v Royal Bank of Canada* [1982] 2 All ER 720, 725.

<sup>88</sup> Gao Xiang and Ross Buckley, 'The Unique Jurisprudence of Letters of Credit: Its Origin and Sources' (2003) 91 (4) *San Diego International Law Journal* 91, 96.

<sup>89</sup> Mann, above n 5, 2495. Mann notes that documents 'are typically the invoice, a packing list, an insurance certificate, and a transport document such as a bill of lading'.

- the principle of strict compliance.<sup>90</sup>

We will briefly examine the application of these principles. Ronald Mann notes that under the principle of independence:

the bank's obligation on the letter of credit is completely separate from any of the contractual obligations of the underlying transaction, either the obligation of the buyer to pay the seller under ordinary principles that govern sales transactions, or any obligation that the buyer might have under an agreement or common-law principles to reimburse the bank for payments made on its behalf under the letter of credit.<sup>91</sup>

Under the principle of strict compliance a bank is bound to make payment on the letter of credit when presented with documents that strictly comply with the conditions of the letter of credit.<sup>92</sup>

Using a letter of credit, a seller can ship the goods to the buyer, with the knowledge that they have a right to payment upon presenting the bank with complying documents.<sup>93</sup> Gillette argues that the result is 'displacement of the buyer as the primary obligor'.<sup>94</sup> The uncertain promise of payment from the buyer is replaced with the promise of a bank.<sup>95</sup>

The value of a promise from a bank has been established in the preceding section of the paper where it was noted that to avoid adverse effects on reputation banks may adhere to commitments even when doing so entails a significant economic cost.<sup>96</sup> This reliability of bank's commitments is meant to be bolstered by the Basle Accord and government regulation of bank capital adequacy. Ronald Mann notes that this additional third party supervision increases the value of a promise 'especially for smaller countries with less stable financial conditions'.<sup>97</sup>

A letter of credit resolves the fundamental problem of exchange by replacing the buyer as obligor with a bank, and by specifying with great detail precisely the documents that will trigger the payment obligation. Thus if the seller has in their hands these documents, before the ship sails bearing their goods, they should be able to be confident of receiving payment.

The problems associated with cross border transactions may further be mitigated by using an issuing bank with an office in the same jurisdiction as the beneficiary, or by

---

<sup>90</sup> Gao and Buckley, above n 89, 119.

<sup>91</sup> Mann, above n 5, 2500.

<sup>92</sup> Gao and Buckley, above n 89, 122.

<sup>93</sup> Mann, above n 5, 2495.

<sup>94</sup> Clayton P. Gillette, 'Letters of Credit as Signals: Comments on Ronald Mann's "The Role of Letters of Credit in Payment Transactions"' (2000) 98 (8) *Michigan Law Review - Symposium: Empirical Research in Commercial Transactions* 2537, 2542.

<sup>95</sup> Mann, above n 5, 2519.

<sup>96</sup> Dinc, above n 22, 781.

<sup>97</sup> Mann, above n 5, 2523.

having the credit confirmed by the beneficiary's bank, which means that a bank in the seller's jurisdiction accepts primary liability on the credit.<sup>98</sup>

Furthermore, courts generally tend to be rigorous in their enforcement of letters of credit. English judges love to use physiological analogies when referring to the need to uphold and enforce credits, describing them as the "lifeblood of commerce",<sup>99</sup> and threatening that "[t]hrombosis will occur if, unless fraud is involved, the courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of cash in hand."<sup>100</sup>

One suspects most judges are at an age when the inevitable decline of the human body begins to exercise its frustrating and morbid fascination.

While rigorous judicial enforcement of credits is widely and often expeditiously available, Katz notes that in letter of credit transactions reliance on formal legal enforcement tends to occur as "endgame" norms ... invoked only in the event that the relationship breaks down'.<sup>101</sup>

### **Bank reputation in letter of credit transactions**

The problem in practice with letters of credit is that strict compliance is so strict, and human beings so fallible, that clerical and other simple errors creep into documents with alarming regularity. Various studies, and expert testimony given in 1990 in the leading case of *Bankers Trust Co v State Bank of India*,<sup>102</sup> point to a discrepancy rate of around 50% in documentary presentations in England and substantially higher rates in Hong Kong and Australia.<sup>103</sup> In other words, when a bundle of documents is presented under a credit in London it will contain at least one discrepant document about one-half of the time, and rather more frequently elsewhere. Accordingly, in the credits in which the beneficiary is not able to cure the deficiency, the applicant is not required to make payment under the credit.

These non-compliance rates were confirmed by Ronald Mann's empirical research in the U.S. in the late 1990s. This inability to meet the standard of strict compliance in a majority of cases raises a very pertinent question, *does our documentary credit system work?*

If banks had to revert to the drawer for instructions upon whether to pay a cheque in the case of more than one-half of cheques presented, the entire cheque clearing procedure would be thrown out as an abject failure. Yet this is what is happening with letters of credit. In a substantial proportion of all letter of credits, the issuing bank has to revert to

---

<sup>98</sup> Mann, id at 2501.

<sup>99</sup> *Intraco Ltd v Notis Shipping Corporation ("The Bhoja Trader")* [1981] 2 Lloyd's Rep 256, 258 (Donaldson LJ).

<sup>100</sup> "The Bhoja Trader", id at 257.

<sup>101</sup> Katz, above n 57, 2569.

<sup>102</sup> [1991] 1 Lloyd's Rep 587 confirmed on appeal to the Court of Appeal at [1991] 2 Lloyd's Rep 443 at 449.

<sup>103</sup> Clive M. Schmitthoff, 'Discrepancy of Documents in Letter of Credit Transactions', in Chia-Jui Cheng (ed), *Clive M Schmitthoff's Select Essays on International Trade Law*, (1988) 431, 432. See also the evidence in *Banque de l'Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd* [1983] 1 QB 711, 733; [1983] 1 Lloyd's Rep 228, 233.

the applicant and ask whether it wishes to waive the discrepancies i.e. whether it still wishes to pay for the goods by means of the credit. Most obviously say they do, and there is the sanction of a suit under the sale of goods contract for those who take the other choice.

Ronald Mann concludes that the documentary credit system works because banks do not 'issue letters of credit indiscriminately'.<sup>104</sup> Mann found evidence which suggests that banks are selective about which customers they will issue credits for. The ability of a customer to reimburse the bank for any payments made on the letter of credit is only one factor that the bank will consider.<sup>105</sup>

Mann argues that bank selectiveness in issuing credit sends two valuable messages about the transaction to the seller. Firstly, the bank is asserting that the buyer will pay and 'will perform according to industry norms in the letter-of-credit transaction'.<sup>106</sup> For example, that minor discrepancies will not be relied upon, and waiver generally will not be unreasonably withheld.<sup>107</sup> As such the seller is assured they will receive payment, even if there are discrepancies in the documents submitted. Secondly, the bank is indirectly verifying "the authenticity" and legitimacy of the transaction,<sup>108</sup> since the seller can safely assume that a reputable bank would not help facilitate an illegitimate transaction.

Mann writes:

In my view, the implicit verification of the applicant's reliability and probity that the issuer makes when it issues the letter of credit generally explains the common usage of letters of credit.<sup>109</sup>

This verification can be relied upon by the seller, since the bank may face reputational sanctions if it is not selective about the applicants for whom it issues letters of credit.

The most important consideration for the applicant is the ability to find a bank willing to vouch for its credit worthiness because this fundamental issue will determine if a letter of credit transaction can be entered into, at all.<sup>110</sup> For the reasons discussed in this paper, if the applicant represents either a credit or reputation risk to a bank, it is unlikely to find a bank willing to vouch for them.

Alternately, the applicant may find only a bank of poor reputation willing to deal with them. The issue then becomes whether the beneficiary/seller will accept a letter of credit from such a bank? Arguably they will not take the risk or will insist on further security to mitigate the risk.

---

<sup>104</sup> Mann, above n 5, 2526.

<sup>105</sup> Ibid.

<sup>106</sup> Mann, id at 2528.

<sup>107</sup> Mann, id at 2525.

<sup>108</sup> Mann, id at 2530.

<sup>109</sup> Mann, id at 2521.

<sup>110</sup> Mann, id at 2524.

## Reputation considerations for the beneficiary

Substituting a bank as the entity obliged to make payment has significant advantages for the beneficiary. It is the reputation of the issuing bank that makes it a valuable substitute for the buyer as the entity promising to make the payment.

However, in spite of the strength of the reputation mechanism for enforcing bank commitments, wise beneficiaries still take care in deciding from which banks they are willing to accept letters of credit.

Strong prudential regulation enhances the value of promises of banks and poor prudential regulation and weak internal governance standards decrease the value of a promise from a bank.<sup>111</sup> The consideration for the beneficiary becomes whether they are willing to accept a letter of credit from a bank that is (i) in a poorly regulated jurisdiction, or (ii) has a reputation for failing to meet regulatory standards, or (iii) is known to have poor internal corporate governance.

Mann came to be persuaded that ‘banks effectively vouch for their customers when they issue letters of credit for them’.<sup>112</sup> While the legitimacy and solvency of the buyer will concern the seller much less once it has secured a promise to be paid by a bank,<sup>113</sup> those issues then, in effect, pass to the bank. In much the same way as the bank must consider reputational issues when deciding what projects it wants to be seen funding (consider the Equator Principles), before agreeing to issue a letter of credit a bank must decide whether it is willing to commit itself to the obligations under the credit on behalf of this particular client because there may well be circumstances during the transaction where the bank’s reputation will be put at risk by the applicant’s actions.

Consider for example the issue of waiver. Empirical research by Mann found a high percentage of discrepancies in the documents presented to the bank by the beneficiary.<sup>114</sup> Under the principle of strict compliance this means that the beneficiary will not be entitled to payment, however the beneficiary may still receive payment if they can cure the defects, or if the applicant waives the discrepancies.<sup>115</sup>

The behaviour of banks in letter of credit arrangements reinforces that banks take promises made by them very seriously. When interviewing bankers, Mann was told that banks are ‘very sensitive about having the letters of credit not paid when they are supposed to be paid’.<sup>116</sup> Other interviews suggested that a bank’s client may be persuaded, or even pressured, by the bank to waive discrepancies.<sup>117</sup> Mann also found

---

<sup>111</sup> Thomson and Jain, above n 25, 50. Consider the results of the survey by McKinsey and Company USA Global Investor Opinion Survey on Corporate Governance (2002).

<sup>112</sup> Mann, above n 5, 2524.

<sup>113</sup> Gillette, above n 95, 2542.

<sup>114</sup> Mann, above n 5, 2502.

<sup>115</sup> Mann, id at 2513. Also Jacob I. Corré, ‘Reconciling the Old Theory and the New Evidence: Comments on Ronald Mann’s “The Role of Letters of Credit in Payment Transactions”’ (2000) 98 (8) *Michigan Law Review - Symposium: Empirical Research in Commercial Transactions* 2548, 2550.

<sup>116</sup> Mann, above n 5, 2525

<sup>117</sup> Ibid.

evidence of banks refusing ‘to continue dealing with major, profitable customers’ if they consider that the customer had displayed ‘a pattern of refusing to waive discrepancies in letter of credit transactions that went beyond normal behavior for the particular industry in question’.<sup>118</sup>

It can be concluded that banks consider the potential subsequent reputational impacts upon themselves of issuing a letter of credit on behalf of a customer, and will not only be concerned about the credit risk posed by the customer.<sup>119</sup>

## **Conclusion**

The fundamental importance of reputation to banks will generally ensure that they adhere to their commitments and are careful in their selection of customers for whom they will grant facilities such as documentary credits.<sup>120</sup>

The need to maintain reputation reinforces the reliability of promises from a bank, and in turn allows parties to enter into letter of credit arrangements to mitigate the risks associated with payment across national boundaries.

Letters of credit may in some ways serve as substitutes for effective credit checks, in other words as substitutes for adequate information on reputation. As Mann identified, attempts by the seller to ‘assess the reputation of the buyer directly often will be expensive and ineffective’.<sup>121</sup> The seller in this case, by insisting on a letter of credit from a bank with which it has an established relationship, or a bank with a well established reputation, can in effect shift the need to assess the credit and reputation of the buyer onto the bank.<sup>122</sup>

It can be concluded that the advantage of a letter of credit arrangement to those engaging in international business transactions is that it grants access to a strong, informal reputational institution. Should the informal institution fail to enforce obligations, legal remedies and the enforcement of rights can be achieved through the established legal framework, but the importance of reputation to banks means this is generally not necessary.<sup>123</sup>

---

<sup>118</sup> Mann, id at 2527.

<sup>119</sup> Gillette, above n 95, 2542.

<sup>120</sup> Dinc, above n 22, 781.

<sup>121</sup> Mann, above n 5, 2522.

<sup>122</sup> Mann, id at 2523.

<sup>123</sup> Katz, above n 57, 2569.