All Banks Are Equal, But Some Are More Equal Than Others: A Look at Interbank Credit Documents

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In 1929 Secretary of State Henry Stimson shut down the State Department's cryptology office, which had decoded foreign diplomatic cables. "Gentlemen do not read each other's mail," he said to explain his decision to go out of the spying business.

The principle of that statement—that some groups have high standards in dealings between members despite how they deal with outsiders—is as old as ancient Rome; it was Cicero who first said, "There is honor among thieves."

What about bankers? Favorite targets of Congressional hearings, newspaper op-eds and Hollywood (remember Mr. Potter of "It's a Wonderful Life"?), do they apply the same rules when dealing with each other as they do when

lending money or credit to ordinary folks?

The answer is yes—but should it be?

Take a look at interbank documents for letters of credit. When a large bank agrees to issue credits for a small bank's customer, it uses documents that duplicate the terms used if the larger bank dealt directly with the customer. Included in the "boilerplate" is an indemnity by which the small bank—like the customer– agrees to make the big bank whole for any losses.

In other words, the little bank gives the big bank an unlimited guaranty to cover any loss—not just reimburse it for draws under the letter of credit.

It is axiomatic that banks can't issue blank checks in other contexts, but this rule is sometimes forgotten with interbank agreements. In fact, it is the better view that banks can't issue indemnities of any kind, since

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banks' powers are limited by statute in order to avoid unlimited claims that may result in losses to federal deposit insurance.

This is not the case under general corporation laws for non-banks, which may conduct any business they want unless it's illegal or governed by a regulatory statute, such as banking and insurance. Where banks have been permitted to issue indemnities the obligation was tied to a trade transaction, as described under former UCC §5-113, for banks that added their indemnity to backstop non-complying documents presented to an issuer. But even that narrow exception is gone, written out of the UCC in 1995.

The solution when your customer really needs the big bank's credit rating on a letter of credit? Cap your bank's indemnity exposure at a percentage of the face amount of the credit, say 105%. That way your customer gets the credit they need, and you don't lose the customer to a bigger bank.