THE ROLE OF THE BASLE STANDARDS IN INTERNATIONAL BANKING SUPERVISION

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Abstract

This paper analyses the emerging international supervisory regime for banking institutions that operate on a transnational basis. It focuses on the basle framework as an institutional regime of norms and principles that govern international financial relations amongst the g10 countries. This paper argues that the basle committee on banking supervision has played a significant role in developing principles of sound regulatory practice for national supervisors to adopt in their jurisdictions. The increasing deregulation and liberalisation of international financial markets necessitates effective international minimum standards of supervisory practice to regulate the international activities of banking institutions. This paper further suggests that the increasing complexity of international financial markets and the need to reduce systemic risk require a global supervisor to coordinate the regulatory activities of national authorities. Indeed, a global supervisor should take the lead in providing information and expertise for national authorities and should, in some cases, take more proactive measures to ensure compliance with international norms.

Keywords: international banking law, international financial markets, international economic order, banks, international policy coordination and transmission.

Jel codes: k29, g15, f02, g21, f42

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1. The Need for Effective International Standards

The liberalization and deregulation of international financial markets have exposed financial systems to an increased risk of systemic failure. Indeed, increasing linkages amongst the world's financial markets have led to a significant expansion in the number, size, and types of activities, and in the organisational complexity of multinational financial institutions. Although these cross-border linkages generally bring efficiency to world capital markets, the increasing scope of international banking activity has highlighted the difficulty of ensuring effective supervision and may, in some cases, increase systemic risk, whereby losses in one banking group can affect the entire financial system.[1] In this situation, systemic risk becomes a negative externality that imposes costs on society at large because financial firms fail to price into their speculative activities the costs associated with their risky behaviour.[2]

Banks have increasingly recognised that traditional methods of risk management have become obsolete and that new measures are needed to assess the risk of new financial instruments. The objective of reducing risk in complex financial markets has led to the diversification of bank earnings that has increased international banking activity with the result that many banks use innovative financial instruments to diversify earnings among several countries so that, in any given year, an inadequate investment outcome in one country may be offset by a positive investment outcome in another country. Expanded and diversified banking operations on an international basis require adherence to a common core of supervisory and regulatory standards recognised by the world's major financial regulators. Moreover, these core international standards require effective international supervision to reduce systemic risk. The first step to achieving effective international supervision is for an international authority to facilitate effective coordination of national regulatory responsibilities and to promote minimum standards and norms of good practice for the supervision of international banking activities.

2. Effective Coordination of Regulatory Responsibilities

As banking becomes more international and deregulated, national regulatory authorities remain the prime supervisors monitoring cross-border banking activities. The lack of an international regulatory framework for financial markets has highlighted the need for effective coordination of international banking supervision. Cross-border banks are locating more operations outside their home jurisdictions to offer cross-border services in which the lending bank and the borrower reside in different countries. This internationalization of financial services has modified the nature of traditional commercial banking through the establishment of complex organisations, known as 'financial conglomerates.'[3] An international financial conglomerate is an integrated group of companies that offers a broad range of financial services. While financial conglomerates offer the benefits of diversified assets, risks, and sources of earnings, their structure poses several problems for regulators. Comprehensive supervision of financial conglomerates requires that supervisors develop standards that address the degree of transparency[4] within the organisation and the placement of overall supervisory responsibility. As mentioned above, the interrelationship of the multinational financial group increases the liklihood that the default or liquidation of an affiliate in one jurisdiction will 'spill-over' to other affiliates or controlled entities in other jurisdictions.[5] Accordingly, the transnational nature of systemic risk requires that national regulatory authorities coordinate their efforts in supervising the international activities of banking institutions, and that they adopt minimum international standards based on the principles of consolidated supervision.[6]

3. Global Supervisor?

Because the stringency of national regulations vary from country to country and because banking is global, multinational banks are subject to disparate levels of regulation that may provide incentives for riskier activities in less stringent jurisdictions. This may increase systemic risk. Since multinational banks now operate in what are becoming seamless financial markets, the effective management of systemic risk on a global level requires a global supervisor whose domain is the same as the multinational entities it regulates.[7] An effective global supervisor must have the expertise and authority to establish minimum standards and rules for the general supervision and regulation of international banking activity. The nature of the international political system, however, precludes such a global supervisor from enforcing standards and rules within the territorial jurisdiction of nation states. Therefore, nation states which adhere to such international principles of banking supervision should agree to undertake the enforcement of international standards at the national level. In this way, a global supervisor would exert more leverage in ensuring that multinational banking institutions are required to internalise the social costs of their operations, and thereby reduce systemic risk.

In addition, there is evidence to suggest that the use of complex financial instruments by offshore hedge funds may increase the risk of systemic failure. Accordingly, banking regulators generally agree that monitoring these financial instruments will be a challenge requiring close international coordination by national authorities. Because of the differences in expertise possessed by various national regulatory authorities, a global supervisor is needed to provide information and expertise and to coordinate transnational regulatory efforts in a manner that affords the benefits of effective international standards to participants in all financial markets.

4. The Emergence of International Soft Law Standards in Banking Supervision: The Basle Framework

The first major banking collapse that focused the attention of the international financial community on the need for enhanced international banking supervision occurred in 1974 and involved major banks from Great Britain, West Germany and the United States. In June 1974, West German authorities closed the Herstatt Bankhaus (Herstatt) following bank losses from foreign exchange dealings,[8] while Britain closed the British-Israel Bank of London for insolvency problems.[9] The closure of Herstatt and British-Israel Bank of London exposed major weaknesses in the international banking system.[10] Shortly thereafter, the Franklin National Bank in the United States collapsed under the combined weight of bad management in the volatile domestic wholesale deposit base, excessive speculation in international foreign exchange markets, and overambitious efforts to expand.[11] Despite such poor management, the US Federal Reserve chose to guarantee the bank's failed short-term foreign exchange commitments.[12] Before the Herstatt collapse of 1974, there was no formal regime for coordinating national regulatory policies with respect to international financial markets. These crises revealed the inadequacy of existing efforts by national regulatory authorities to address transnational financial crises and thus promoted the creation in 1974 of an international standing committee of banking supervisors.[13] The international committee was composed of the banking supervisors and central bank governors of the G-10 countries. It became known as the Committee on Banking Regulations and Supervisory Practices,[14] which later became known as the Basle Committee on Banking Supervision.[15] The Bank for International Settlements provided administrative offices for the Basle Committee. The Basle Committee has since played a major role in establishing voluntary principles and standards of 'best practices' for national supervisors to adopt in regulating the international operations of banking institutions.

5. Basle Concordat

The Basle Committee attracted very little attention until 1975 when, in response to the banking failures mentioned above, it adopted the Basle Concordat of 1975 ('Concordat') that established guidelines for banks operating outside their home states. The Concordat focused on the respective roles of the home and host state supervisors and regulatory authorities to ensure adequate financial supervision.[16] Specifically, it established five basic principles delineating the supervisory responsibilities of home and host countries' banking regulators in overseeing banking institutions that operate on a transnational basis. The Concordat emphasised that all banks operating in host countries should be supervised by both the home country's and the host country's supervisory authorities.[17] It recommended that the host authority take primary responsibility for the adequacy of the foreign bank's liquidity.[18] The home country's supervisory authority should, in turn, be primarily responsible for the solvency of a home country's bank whilst that bank is operating in a foreign country.[19] The need for cooperation between home and host country regulatory authorities necessitated the fifth principle of the Concordat, which recommended removal of all legal restraints on the transfer of information.[20]

6. 1983 Revised Concordat

The Latin American sovereign debt crisis of the 1980s involved government defaults on bond payments that resulted in systemic risk and excessive capital flight from financial institutions.[21] As a result, the Basle Committee members recognised the need to develop specific supervisory standards to be shared by national regulatory authorities. Accordingly, the Committee in 1983 revised the Basle Concordat by adopting Principles for the Supervision of Banks' Foreign Establishments ('Revised Concordat').[22] The Revised Concordat established new principles for the allocation of bank regulatory responsibilities between home and host authorities.[23] Moreover, the Revised Concordat focused on ensuring that no bank operating in a foreign country could escape adequate supervision, and, hence, developed the approaches of 'consolidated supervision' and 'dual key' supervision.[24] Consolidated supervision means monitoring the risk exposure (including the concentrations of risk, the quality of assets, and the capital adequacy) of the banking groups for which the home authority bears responsibility, on the basis of totality of the business, wherever conducted. Consolidated supervision expands the responsibilities of the home country's regulatory authority by requiring the home country regulator to monitor the total risk exposure and capital adequacy of the home country's bank.[25] The home country regulator is able to do so by reviewing the bank's total transnational operations.[26]

In contrast, 'dual key supervision' means that the regulatory authority of each nation concurrently assesses the ability of other national authorities to supervise and carry out their respective responsibilities. Where a host country determines that a home country has inadequate supervision, the Revised Concordat proposes two options: (1) the host country could deny entry approval to an institution from a country which does not adequately supervise its own institutions,[27] or (2) it could impose specific conditions for foreign banks governing the conduct of the business of such establishments.[28] When a host country does not have adequate supervision, the Revised Concordat urges the home country's regulatory authorities to discourage the home country's bank from expanding its operations into the proposed host country.[29] The purpose behind the dual-key approach was to prevent countries from lowering supervisory practices in order to attract foreign investment and foreign capital.[30]

In 1990, the Basle Committee issued the Supplement to the Revised Concordat of 1983, known as 'Information Flows between Banking Supervisory Authorities (Supplement)'.[31] This supplement reiterated the need for adequate cooperation and communication amongst regulatory authorities in order to improve the quality of supervision of cross-border banking.[32] The Supplement emphasised that developing mutual trust between supervisory authorities required that information be able to flow unhindered to both home and host countries.[33] The Supplement recommended, therefore, that supervisory authorities undertake an affirmative commitment to cooperate with each other on all prudential supervisory matters.

7. Minimum Standards for International Banking Groups

Although the Revised Concordat and the 1990 Supplement improved the standards that were initially set forth in the Basle Concordat of 1975, significant gaps in the allocation of supervisory responsibilities still existed. For example, the collapse of the Bank of Credit and Commerce International (BCCI) in July of 1991 resulted, in part, from BCCI's ability to evade supervision by both home and host countries and demonstrated the difficulties of adequately supervising banks operating in more than one jurisdiction.[34] Indeed, the BCCI case raised serious questions about the regulation of cross-border financial institutions.[35] The BCCI scandal led to the Basle Committee's 1992 Report on Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishment (Minimum Standards). These minimum standards continued to build on the principles of consolidated supervision, dual-key supervision, and communications between supervisory authorities, while setting forth guidelines for the implementation of these principles. The standards are important principles that reflect emerging norms of prudential supervision and regulation of transnational financial institutions. They can be summarised as follows:

(1) All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision.
(2) The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's, or banking group's, home country supervisor.

(3) Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor.

(4) If a host-country authority determines that any one of the foregoing minimum standards has not been met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of a banking establishment.[36]

By reemphasizing the need for consolidated supervision, the Minimum Standards recommend that the host country regulators ensure that the home country receives consolidated financial statements of the bank's global operations. The Minimum Standards further exhort that the home country's regulators have the means to satisfy themselves as to the completeness and validity of all financial reports.[37] In addition, the host country's regulators should assure themselves that the home country's regulators have the authority to prevent banks under their jurisdiction from establishing organisational structures that circumvent supervision.

Furthermore, the Minimum Standards advocate that the host country ensure that the home country's supervisory authorities have consented to the establishment of the foreign branch.[38] Additionally, the host country should determine whether the organisational structure of the operation is likely to cause confusion as to the appropriate allocation of supervisory responsibilities. If the organisational structure has this potential for confusion, the host country is advised to ensure that the other countries are actually aware of their expected responsibilities and are willing to perform them. The Minimum Standards also encourage both the host and home country to assure themselves of the right to gather information concerning foreign operations. Finally, the Minimum Standards recommend that if any other minimum standards are not met in the home country, and if no other restrictive practices are available to help assure the safety of the bank on a 'stand alone' basis, the host country should not allow banks from the home country to establish foreign branches in their country. This process effectively requires the host country to decide whether the home country's authority meets the Minimum Standards.[39]

8. Basle Accords

In light of the precipitous decline of the US and most European stock markets (Black Tuesday) in1987, the Basle Committee began to explore the need to prevent financial crises caused by disorderly capital movements, and to ensure the capital adequacy of financial institutions. Indeed, the Basle Committee responded to the concern of banking regulators that the capital requirements of major banks did not reflect the true risks facing banks in a deregulated and internationally-competitive market. Subsequently, the Basle Committee adopted a set of guidelines on the capital adequacy of banks in 1988.[40] These guidelines became known as the Basle Accord on Capital Adequacy,[41] which advocated two principal goals: (1) to require banks to maintain higher levels of capital reserves by maintaining capital-to-asset ratios that are 'risked-based' (i.e. that reflect the real credit risks as well as the risks of banks' off-balance sheet portfolios);[42] and (2) to establish a level-playing field so that a bank based in one country would not receive a competitive advantage by enjoying a lower capital adequacy requirement than a bank based in another country.[43] Although these guidelines are not legally binding, they have been incorporated into the national banking regulations of the G-10 countries and a number of other countries as well.

In addition, the Basle Committee also seeks to prevent banks from facilitating criminal activity. It has formulated a plan to encourage (1) vigilance against criminal use of payment systems; (2) implementation of effective preventive safeguards; and (3) cooperation with law enforcement agencies. The Basle Committee also established an ethical code of conduct for central bank supervisors to prevent and monitor financial frauds such as money laundering. In December of 1988, the Basle Committee issued the Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering accord. [44] The Money Laundering Accord assists bank regulators in preventing criminals from using the banking system to launder money, and attempts to ensure the integrity of the banking system by prohibiting financial institutions from associating with criminal activity.

On 12 April 1995, the Basle Committee developed a new approach to the calculation of capital requirements.[45] The approach allows banks, for the first time, to use their internal risk-management models to determine regulatory capital requirements. Instead of adhering to a detailed framework for computing risk exposures (for reporting purposes) and capital requirements, banks are able, under certain conditions, to use their own models—the ones they use for day-to-day trading and risk management—to determine an important component of their regulatory capital requirements. In particular, the Basle Committee advocates value-at-risk as the standard measure for risk exposures. Value-at-risk is an estimate of the maximum loss in the value of a portfolio or financial system over a given time period with a certain level of confidence. This level of confidence is represented by the probability that the actual value of a particular capital account will not decline beneath a specified minimum value over a period of time at a given probability. Value-at-risk also refers to the requirement of closer involvement with the banks under supervisory control and formal risk assessments using appropriate evaluation factors. The Basle Committee adopted the value-at-risk model in 1997 and it has been implemented into law by the major national regulators. Banks are encouraged to participate in the design framework for determining risk weightings for particular asset classes.[46]

More recently, the Basle Committee released the Basle Core Principles (Core Principles) for Effective Banking Supervision which set out twenty five Core Principles for an effective supervisory system.[47] The Core Principles are comprehensive in coverage and include guidelines for effective banking supervision, licensing and structure, prudential regulation and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors, and cross-border banking.[48] The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities worldwide in the supervision of all banks within their jurisdictions. Since 1998, supervisory authorities throughout the world, including the G-10 countries, have endorsed the Core Principles.[49] The Basle Committee believes that the adoption of the Core Principles by the major countries and financial markets of the world is a significant step in improving both domestic and international financial stability.

In many countries, however, the supervisory authorities do not have the statutory authority to implement all of the Core Principles. In such countries the powers of supervisors are very limited, and subject to direct political control. The Basle Committee has strongly encouraged legislators in these countries to make the necessary changes to ensure that the Core Principles can be effectively implemented. Any need for new legislation will be taken into account by the Basle Committee in monitoring the time it takes to progress toward implementation.

Given the importance of capital adequacy to the soundness and safety of banks, the Basle Committee will continue to pursue the Basle Accords in high-risk areas in international banking, and in key elements of banking supervision primarily through heightened capital adequacy. The Basle Accord will serve as a reference point for future work in association with other international financial organisations, including international securities, insurance, and accounting organisations. Over the past several years, the Basle Committee has cooperated with International Organization of Securities Commissions and the International Association of Insurance Supervisors and several other international financial organisations to develop international financial supervisory standards in the areas of banking, securities, and insurance. It has worked with IOSCO on converging capital adequacy standards for financial institutions conducting securities activities in derivatives. It has also worked with the International Accounting

Standards Committee and International Accounting Federation on financial institutions' accounting standards.[50] Finally, the Basle Committee will also encourage work at the national level to implement the Basle Accords in conjunction with non-banking supervisory bodies and interested parties, and intends to strengthen interaction with banking supervisors from non-Basle countries, and to continue non-technical assistance and training in non-Basle countries.

Similarly, IOSCO has made parallel efforts on the international level to improve cooperation, coordination, and harmonization of securities and futures and regulations.[51] IOSCO has also sought to formulate capital adequacy ratios for securities firms to match those already existing for banks under the Basle Accords.[52]

9. Basle Accords and Prudential Supervision

The primary purpose of the Basle Committee has been to provide a forum for international banking sectors to discuss and apply various standards and measures of prudential supervision to banking institutions that operate in the financial markets of leading countries.[53] In a general sense, prudential supervision means a conscientious enforcement of banking regulations by banking supervisory authorities. The Basle Committee envisions prudential supervision as the core value for banking supervision. The aim of the Basle Committee has been to aid in developing a coordinated, non-duplicative, and comprehensive system to supervise international financial institutions. Prudential supervision is dependent upon a full appreciation of the infrastructure of a particular country's banking law, and the evolution and future development of the country's particular banking law and system.[54] This contextual approach acknowledges the importance of the commercial, social, and economic factors within which banking laws develop. With this understanding, bank regulators can determine whether and how banking laws allow for prudential supervision. The concept of prudential supervisory regulation is a constant reference point, and a basis for maintaining the stability and integrity of a banking system.[55]

Thus, the supervisory authorities of highly developed countries have been given broad discretion in formulating, applying, and enforcing this core value.[56] The two most striking examples of the traditional but developed systems that have utilised prudential supervision are those of the United Kingdom and the United States.

9.1. United Kingdom

Prudence as a core value in the UK's banking system emerged for the first time in the 1979 Banking Act's statutory requirement that all banks conduct their business in a 'prudent manner'.[57] In terms of prudential supervision, the Bank of England emphasised bank stability. Later, in 1987, the revised Banking Act established a 'safety net' providing that an institution shall not be regarded as conducting banking business 'in a prudent manner' unless it maintains or will maintain appropriate standards of capital adequacy, adequate liquidity, adequate provisions, adequate accounting and internal control systems, and generally prudent conduct.[58]

9.2. United States

The United States's notion of prudential supervision is often articulated as 'safety and soundness'. The safety and soundness idea derives from post-1930 banking law provisions in the Glass-Steagall Act that granted US federal and state banking supervisory agencies broad discretionary powers.[59] In addition, US banks were specifically prohibited from engaging in any 'unsafe or unsound practices'.[60]

Similarly, the idea of prudential supervision has been adopted in the laws of many countries, and has become carefully preserved in some well-planned banking supervisory frameworks. For example, the UK, US and European Union constructed their banking regulations using the core value of prudential supervision under the recommendation of the Basle Accords.[61] Partly because prudential supervision generates self-regulation within the banking industry, the prudential supervision standard has become a cornerstone for development of banking regulations by legislators and banking supervisory authorities.

The Basle Committee utilises the core value of prudential supervision in the Basle Accords.[62] The Accords focus on the legal powers of home bank supervisors and the resources available for the regulation of banks on a worldwide basis. Specifically, the Basle Accords ensure that banks have adequate management information systems and internal controls, set minimum capital standards, and allow regulators to take corrective action when banks fail to meet the Basle Committee's requirements. The European Union, the United States and many G-10 countries have adopted a Minimum Capital Adequacy Ratio similar to that of the Basle Committee.[63] Further, these governmental authorities have utilised the Basle Committee's recommendations to set regulation limits on loans and liquidity ratios.[64] Because the European Union, the US, and other G-10 countries are representative of the major industrialised countries of the world, their adoption of the Basle Accords indicates a move to coordinate financial supervisory standards in the larger context of an international financial system.[65] Based on these examples, other countries in the world which share a common interest in sound and safe banking supervision at the international, as well as the local level, will inevitably adopt the Basle Accords.[66]

10. The Basle Accords as International Minimum Standards and the Harmonization of National Banking Regulations

In the international convergence context, two aspects of financial regulation merit special consideration: (1) effectiveness of regulation in applying prudential principles, and (2) the proper development of competition in the financial services market.[67] The Basle Accords address the concern that international financial regulation may conflict with traditional notions of sovereignty and national control over a state's banking system. The Basle Accords addresses this concern by preserving the effectiveness of existing national regulations and fostering competition among supervised banks by conducting peer reviews to evaluate a country's efforts at adopting the Accords.[68] Moreover, the voluntary approach takes account of different regulatory systems by allowing a country flexibility in the way it implements the Basle Accords. Conventional wisdom asserts that once most countries' banking authorities adopt the prudential formulae of the Accords, competition will flourish in international banking markets.[69]

The Basle Committee does not seek to unify all national laws and regulatory practices, but rather to link disparate regulatory regimes with a view towards ensuring that all banks are supervised according to common principles. This objective may also be viewed as promoting gradual transnational convergence of supervisory practices governing financial institutions. Although the Accords are not legally binding, the Basle Committee encourages member nations to adopt these regulatory guidelines by enacting and enforcing them under national law, and to facilitate cross-border coordination and communication.[70] While regulatory theories have traditionally developed in a single-country context, there is no single theory of regulation that provides a satisfactory explanation of the international dimension of regulation. For example, the Basle Capital Adequacy Accord is a universal benchmark that greatly influences the decision-making of international banks. Some bankers and policymakers, however, view the Accord as increasingly and unfairly penalising certain low-risk lending while favouring other much more risky types of transactions. Consequently, many of these bankers favour domestic regulations over the Basle Accords' universal principles on capital adequacy. Nonetheless, the advent of global banking has made it possible for a network of depository institutions to be linked by sophisticated telecommunications and computer systems. The creation of such networks will expose the inadequacy of domestic government regulation. Moreover, banking sectors throughout the world will likely be required to participate in a single network of international payments and deposits that would be a closed system to which all reputable banks will have to belong and for which a common, transnational regulatory framework will be required. Accordingly, an international regulator could play a role by supervising such an international payments system and providing minimum standards to reduce systemic risk.

11. The Necessity of Extraterritorial Regulation

In the absence of a supranational regulator, there is a disjunction amongst national regulatory regimes because many national legal systems will not regulate the activities of persons or transactions that are not exclusively located within their territorial jurisdictions. In sophisticated financial markets, there is a need for national authorities to adopt regulations with extraterritorial effect that allow them to impose jurisdiction on foreign persons or transactions occurring outside territorial borders, but which affect the financial markets of the regulating state. Some scholars have argued that a strict application of territorial principles of jurisdiction may result in inadequate regulation of cross-border financial services.[71] Other scholars argue that when national regulators are permitted to regulate on an extraterritorial basis, they have a tendency to 'over-regulate' their territorial markets (thus causing inefficiencies) in order to bring extraterritorial activities within their jurisdictional control.[72]

Moreover, the unilateral application of extraterritorial financial regulation would likely introduce a number of political and legal problems between national authorities. This could be ameliorated by adopting international agreements – either treaties or voluntary mutual assistance agreements – whereby national authorities agree on minimum standards of prudential supervision that would apply to all member states. Alternatively, countries can agree on a method for determining which country's substantive rules apply or govern a particular transaction. Different approaches may be appropriate for different regulations.[73] Even if such inter-state agreements were adopted, it may still be necessary to have a international financial supervisor monitor and facilitate the enforcement of such agreements.

Given the non-legal nature of the Basle Committee's pronouncements, a successful intergovernmental regime is dependent on the effective enactment of appropriate legislation by member states. A successful framework of international supervision requires each country to amend its domestic laws and approve international agreements or conventions in accordance with international banking supervisory standards. Pursuant to the Basle Accords, banking supervisors must practise globally consolidated supervision. The Basle Accords provide adequate monitoring and appropriate prudential norms for all aspects of transnational banking. Most important, the Accords address the home countries' efforts at supervising foreign branches and subsidiaries of a home country's banks. The Accords contain a national treatment standard whereby host country banking supervisors require the local operations of foreign banks to be subjected to the same regulatory standards as those of domestic institutions. Moreover, host countries' banking supervisory agencies must share information needed by the home country supervisors for the purpose of implementing consolidated supervision.[74]

12. Soft Law as the Basis for a Global Authority

International financial networks operating in regions with differing bank regulations pose systemic risks. The systemic risks inherent in international banking include: (1) global systemic risk – the risk that the world's entire banking system may collapse in response to one significant bank failure; (2) safety and solvency risks that arise from imprudent lending and trading activity; and (3) risks to depositors through the lack of adequate bank insurance. Financial fraud activities also pose a significant threat to an internationalised banking industry.

International soft law may be defined as non-binding principles or standards of state practice adopted by states because they perceive it as being in their interest to do so, and not because of a pre-existing legal obligation. Soft law in the banking supervision context may be viewed as a flexible arrangement whereby banks from different countries with different domestic banking regulations are permitted to work together under one set of international banking standards. Due to the nature of soft law, the banks of two different nations may do business with one another without one insisting that the other follow an unfamiliar foreign law. Because of this advantage, banking regulators recognise the benefit of soft law in establishing a global banking supervisory regime.

The emergence of soft law principles in the Basle framework provides a set of international soft law norms that a global supervisory authority could utilise as a basis to encourage national regulators to adopt standards of good practice in the regulation of financial markets. The sheer number of worldwide banking financial activities require a recognised authority to provide minimum standards and to monitor national enforcement regimes. The volume of transnational activity is increasing beyond the responsive capability of national regulatory systems, and necessitates a global authority to facilitate the adoption of minimum international standards by national authorities to ensure adequate supervision and capital adequacy of banking institutions that operate on a global basis. By adopting soft law principles, national legal systems can facilitate the emergence of a transnational supervisory system that can cope with global banking crises in any part of the world. Because the Basle Concordats and Accords have become the standard of choice in major financial markets, they have reached the level of international soft law whose methodologies should apply to all international financial intermediaries. Without these transnational principles, the inefficiencies inherent in divergent banking supervisory systems may render the international banking system unable to prevent the types of behaviour by banks that may lead to systemic volatility and increased fragility in international markets.

A global authority should not only develop effective international standards, but also foster effective coordination and cooperation amongst national authorities in sharing information and enforcing international standards. Moreover, as espoused by the Basle Accords, national authorities should share responsibility for banking supervision, and have allocated the responsibility for supervising a foreign branch to both home and host country regulators. Sharing responsibility in this manner should reduce the chance that a foreign branch will completely escape supervision. Consequently, implementation of the Basle soft law standards would preserve the main regulatory concerns of regulatory effectiveness and competitiveness.

13. Conclusion

It has become apparent through early attempts at coordination by the Basle Committee that the international activities of banks are subject to overlapping and disjointed national regulatory structures. The implementation of the Basle Accords, however, on a voluntary basis by the major national banking regulators would allow banking supervisors to overcome disagreements among national regulatory standards that result from different political and economic interests. The 1988 Capital Adequacy Accord is an example of national authorities proposing, adopting and implementing a soft law framework devised at the international level to be given hard law effect within national legal systems. The adoption of the Basle Accords into the laws of many countries is an example of the process of legalization that involves no delegation of supervisory compliance to an international body.

On the other hand, given the nature of systemic risk in the international financial system and the current regulatory system's disjointed approach to financial regulation, there should be serious consideration given to the creation of an international financial authority that would perform some of the functions that are currently handled by national authorities. An international authority could establish minimum standards of prudential practice and monitor compliance with such standards. Naturally, given the political realities of the international system, this approach would involve national authorities enforcing standards that are set by an international authority. It is necessary to establish effective international minimum standards to reduce systemic risk in the international financial system, and to ensure that such standards are enforced at the national level. Ensuring stable and prosperous economic growth in the world economy of the twentieth first century may require some type of international authority to devise precise and binding rules and standards to reduce systemic risk, while relying on national enforcement authorities to ensure compliance.

Notes

1. General Accounting Office, 'International Banking, Strengthening the Framework for Supervising International Banks' (Mar., 1994) 6 [hereinafter GAO].

2. J.L. Eatwell & L. Taylor, *Global Finance At Risk: The Case for International Regulation*, Report, World Financial Authority Project (Cambridge: 1999).

3. The term 'financial conglomerates' includes at least one financial component in an industrial or commercial operation. See G. Walker, 'The Law of Financial Conglomerates – The Next Generation,' 30 *Intl Law* 57 (1996).

4. Transparency requires full disclosure of information about the entire operations of a multinational financial conglomerate, including financial groups of the conglomerate, parent companies, and its subsidiaries. See J. Freis, Jr., 'An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in Finanzplatz Deutschland,' 19 *B.C. Intl' & Comp. L. Rev.* 1, p. 11 (1996)(assessing increased transparency of German financial markets, improved investor's rights, and regulating participation in stock exchanges and securities markets).

5. The risk of contagion occurs where losses in one activity reduce the capital available to support other parts of the group, or where visible difficulties in one affect confidence in other areas of the same group. See K.E. Scott, 'Deposit Insurance – The Appropriate Roles for State and Federal Governments', 53 *Brooklyn J, Intl' L.* 27, p. 35 (1987).

6. Walker, *supra* note 3, p. 71. This may require firewall provisions to protect both consumers and taxpayers against possible conflicts of interest, and to prevent the spread of a

national safety net (deposit insurance) provided to banks, and any associated subsidy, from spreading, to non-banking activities.

7. J. L. Eatwell & L. Taylor 'The Future of Financial Regulation: World Financial Authority' (April, 1999) Working Paper, Center for Economic Policy Analysis, New School of Social Research.

8. See R. Dale, *The Regulation of International Banking* (1984) 156.

9. E. Kapstein, Supervising International Banking, (1991) 4.

10. D.J. Peake, 'International Banking: Regulation and Support Issues,' in *U.K. Banking Supervision: Evolution, Practice and Issues* (E.P.M. Gardner, ed. 1986) 186.

11. See R. Dale *International Banking Regulation* (1992) 171.

12. Peake, supra note 10, p. 186.

13. Dale, supra note 11, p. 172.

14. See J.J. Norton, (1995) *Devising International Bank Supervisory Standards* p. 176.

15. P. Cooke, 'The Basle Concordat on the Supervision of Banks' Foreign Establishments', 39 *Aubenwirtshaft* 151, p. 153 (Basle: BIS, 1984).

16. *Ibid.*

17. *Ibid.*
18. *Ibid.*

19. *Ibid.*

20. Cooke, supra note 15, p. 246 (summarising the Basle Accords).

21. D. Alford, 'Basle Committee Minimum Standards, International Regulatory Response to the Failure of BCCI,' 26 *Geo. Wash. J.Int'l L. & Econ*. 241, p. 250 (1992).

22. Basle Committee, 'Principles for the Supervision of Bank's Foreign Establishments' [hereafter Revised Concordat] (May 1983).

23. *Ibid.*

24. *Ibid.,* p. 905.

25. *Ibid.*

26. *Ibid*., p. 904.

27. According to the Revised Concordat, the primary purpose of the Basle Committee is to examine the totality of each bank's worldwide business on the basis of consolidated supervision. See The Revised Concordat, supra note 22. The Revised Concordat of 1983 revised the earliest publication of the Basle Concordat of 1975. See The Basle Committee, 'Report to the Governors on the Supervision of Bank's Foreign Establishments' (Sept. 1975); 'Principle for the Supervision of Bank's Foreign Establishments' (May, 1983), reprinted in 22 ILM 900 (1983).

28. *Ibid.*

29. *Ibid.*

30. See Alford, supra note 21, p. 253.

31. Basle Committee, 'Information Flows Between Banking Supervisory Authorities' (April 1990) 1.

32. Basle Committee on Banking Regulation and Supervisory Practices: 'Supplement to the Basle Concordat on Ensuring of Adequate Information Flows between Banking Supervisory Authorities' (Apr. 1990) available in LEXIS, IntLaw Library, BDIEL File.

33. *Ibid.*

34. See P. Truell & L. Gurwin, *False Profits: The Inside Story of BCCI, The World's Most Corrupt Financial Empire* (1992)(describing the rise, fall and prosecution of BCCI).

35. BCCI was able to evade supervision by establishing a holding company in Luxembourg. Consequently, the BCCI entity held two parent (or home) banks: BCCI S.A., incorporated in Luxembourg, and BCCI Overseas, incorporated in the Cayman Islands. Each of these banks had subsidiaries in foreign countries. This structure gave BCCI the ability to evade consolidated supervision. BCCI had two parent banks for which two countries held overall regulatory responsibility, but neither of the parent banks conducted its primary operations in those countries. This problem was compounded by the secrecy laws of the Cayman Islands and Luxembourg. See L.C. Lee, *Better Late Than Never: European Union 'Post-BCCI Directive on Prudential Supervision*' (1992).

36. The Basle Committee, 'Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments' (July, 1992) 3-7.

37. *Ibid.*

38. *Ibid.,* p. 6.

39. *Ibid.*

40. The capital adequacy guidelines are printed in Bank for International Settlements: Committee on Banking Regulations and Supervisory Practices, 'International Convergence of Capital Measurement and Capital Standards', *reprinted in* 30 ILM 980-1008 (1991)(introductory note by Cynthia Lichenstein).

41. The Basle Committee released 'Banking Regulations and Supervisory Practices, International Convergence of Capital Measurement and Capital Standards', *reprinted in* 51 *Banking L. Rep. (BNA)* 143 (July 25, 1988)[hereinafter Capital Adequacy Standards].

42. See H. Scott & S. Iwahara, *In Search of a Level-Playing Field, The Implementation of the Basle Committee Accord in Japan and the United States* (New York: Columbia, 1994) 2.

43. *Ibid.*, p. 3.

44. To assist the suppression of money laundering through the banking system, the Basle Committee sets out a four-part plan: customer identification; compliance with laws; cooperation with law enforcement authorities; and adherence to the Statement. See Basle Committee, 'Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering' (December 1988)[hereinafter Money Laundering Accord].

45. See Basle Committee, 'An Internal Model-Based Approach to Market Risk Capital Requirements' (April 1995)(defining a series of quantitative and qualitative standards that banks would have to meet in order to use their own system for measuring market risk).

46. See discussion of value-at-risk method in D. Folkerts-Landau and T. Ito, 'International Capital Markets Developments, Prospects and Policy Issues' (IMF Working Paper, Aug. 1995) 135.

47. The Basle Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision', September 1997 [hereinafter Basle Core Principles]. These principles are designed to be applied by all countries in the supervision of banks in their jurisdictions. See G. Graham, 'Focus on a Set of Core Principles,' *Fin. Times*, 19 Sept. 1995, at xiv & xv.

48. See Basle Core Principles, p. 1.

49. The Core Principles were drafted by the Basle Committee in close consultation with fifteen emerging market countries; and the Basle Committee has also consulted with many other supervisory authorities.

50. See GAO, supra note 1, p. 28.

51. P. Guy, 'Regulatory Harmonisation to Achieve Effective International Competition', in F.R. Edwards and H.T. Patrick (eds.) *Regulating International Financial Markets: Issuers and Policies* (1991) 291.

52. International Organization of Securities Commissions: Technical Committee Report on 'Capital Adequacy Standards for Securities Firms' (Aug. 1989) reproduced in 30 *International Legal Materials* (1991) 1018; see also, 'Methodologies for Determining Capital Standards for Internationally Active Securities', Technical Committee of IOSCO (May, 1998).

53. C. Lichtenstein, 'Introductory Note, Bank for International Settlements: Committee on Banking Regulations and

Supervisory Practices' Consultative Paper on International Convergence of Capital Measurement and Capital Standards' [July 1988] 30 ILM 967-78 (1991).

54. See R. Cranston, 'Understanding Banking Law,' *Lloyd's Maritime and Com. L. Q.* 360 (Aug. 1988).

55. Groos National Bank v. Comptroller of the Currency, 573 F.2d 889, 897 (5th Cir. 1978)(holding that the phrase 'unsafe or unsound banking practice' is widely used in the regulatory statutes and case law)

56. See Survey of Banking in Emerging Markets, 'Fragile, Handle with Care' *The Economist* (Apr. 12, 1997) p. 13.

57. See 'Banking Supervision, Fact Sheet' of Bank of England, (Oct. 1993), p. 1 (expressing that the mechanisms to supervise banks under the Bank of England refer to 'prudential supervision' which aims at limiting bank's risk exposure and probability of failure).

58. G. Penn, *Banking Supervision: Regulation of the UK Banking Sector Under the Banking Act 1987* (1989) 23-32.

59. See J. Horne, 'Memorandum on "Unsafe or Unsound Practice" as a Basis for Issuance of a Cease and Desist Order' (printed into Senate Record), 112 Cong. Rec. 26474 (Oct. 3, 1966).

60. 12 U.S.C.A. § 1464(d)(4)(A); 12 U.S.C.A. § 1818 (e)(1)(c).

61. See F.C. Musch, 'Applying Basle Standards in Developing and Transition Economies', in *Banking Soundness and Monetary Policy, Issues and Experiences in the Global Economy*, (C. Enoch, J. Green eds., 1997) 130, 133.

62. See Norton, *supra* note 14, p. 157.

63. See GAO, 'Securities Markets: Challenges to Harmonising International Capital Standards Remain', (1992) 12-62.

64. See R. Litan, 'Nightmare in Basle, Intl' Economy,' Nov-Dec. 1992, at 7.

65. A. Lucatelli, *Financial and World Order, Financial Fragility, System Risk, and Transnational Regimes* (1997) 77.

66. *Ibid*.

67. R. Cranston, *Principles of Banking Law* (1997) 113-16.

68. See H. Scott & S. Iwahara, 'In Search of a Level Playing Field, The Implementation of the Basle Accord in Japan and the United States' (1994) 2.

69. *Ibid.,* p. 1.

70. See P. Cooke, 'Development in Co-operation Among Bank Supervisory Authorities', 3 *J. Comp. L. & Sec. Reg.* (1981).
71. See R.M. Pecchioli, *The Internalization of Banking: The Policy Issues* (New York: Oxford, 1983) 63-70.

72. Cf. remarks of John L. Eatwell, International Financial Regulation Lecture Series (26 Nov. 1999), University of Cambridge.

73. See S.J. Key & H. Scott, *International Trade in Banking Service: A Conceptual Framework* (1991)(suggesting a matrix for analysis of different types of bank regulation, with a view toward clarifying the rules that should govern international trade in banking services and separating the regulatory decisionmaking between home and host country). See also, analysis Home and Host Country Financial Regulation in the European Union, in E. Ferran, 'European Financial Service

Regulation', Unpublished Working Paper, World Financial Authority Project (Cambridge, Queens' College: June 5, 1999).

74. See H. S. Scott, 'Supervision of International Banking Post-BCCI', 8 Ga. St. U. L. Rev. 487-510 (1992).

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