

2-1-2004

The Role of the Bank for International Settlements in Shaping the World Financial System

Carl Felsenfeld

Fordham, cfelsenfeld@law.fordham.edu

Genci Bilali

Pinci & Associates, PLLC, New York, NY

Follow this and additional works at: http://lsr.nellco.org/fordham_oc



Part of the [Banking and Finance Commons](#), and the [International Law Commons](#)

Recommended Citation

Felsenfeld, Carl and Bilali, Genci, "The Role of the Bank for International Settlements in Shaping the World Financial System" (2004).
Fordham Law School Occasional Papers. Paper 1.
http://lsr.nellco.org/fordham_oc/1

This Article is brought to you for free and open access by the Fordham University School of Law at NELCO Legal Scholarship Repository. It has been accepted for inclusion in Fordham Law School Occasional Papers by an authorized administrator of NELCO Legal Scholarship Repository. For more information, please contact tracy.thompson@nellco.org.

THE ROLE OF THE BANK FOR INTERNATIONAL SETTLEMENTS IN SHAPING THE WORLD FINANCIAL SYSTEM

Carl Felsenfeld, Professor of Law, Fordham Law School

Genci Bilali, Previously General Counsel of the Central Bank of Albania, Attorney at Law, Pinci & Associates, PLLC, New York, NY. This article does not necessarily represent the views of the firm or its clients.

ABSTRACT

The Bank for International Settlements (BIS) was set up in Basle, Switzerland in 1923 to handle remaining financial issues from World War II largely having to do with German reparation payments. It was the first of the semi-public international banks. Over the years its functions have changed and, largely since the late 1970s, it has served as the situs for the world's central banks and financial regulators to pool their thinking and deal with international financial issues. A group of committees composed largely of representatives of central bankers now meet at BIS and have been issuing memoranda and drafts of regulations on a number of subjects affecting international banking. Among these are the regulation of capital, the management of international conglomerates and problems resulting from electronic banking.

Problems in world banking have sensitized observers to the absence of coordinated regulation and to the need for some form of unified control. That there is a need for one international bank regulator is increasingly acknowledged. BIS in Basle comes closer than any other organization to fulfilling this function. The International Monetary Fund comes close but is too politicized and has been too involved in attempting to meet a continuing series of crises to do any long range thinking. Only BIS has attracted the intellectual resources to analyze and resolve international problems in a thoughtful and deliberate manner. And only the BIS output is being adopted in the world's banking centers.

BIS has been proposed as a world senior financial regulator. The article acknowledges the rationale for such a decision but argues that now is not the time for such an attempt. Banking is, of course, conducted locally even though its reach is international. To anoint any body as a senior regulator with the power to impose its rules would require a massive set of compromises among national regulations in order to achieve one central set of rules. It would also essentially involve an abdication of measures of sovereignty by the constituent states. An effort of this kind would risk destroying the whole concept. Rather than start such a bold stroke at such an inopportune time, the article argues that the international banking world would fare far better assisting BIS to proceed down the track it is already on. As it continues to mature and as its edicts are increasingly accepted throughout the world it will continue to approach its rightful place as the world's bank regulator.

I. Introduction

II. Profile of The Bank for International Settlements

III. Start of International Bank Supervision Authority

A. BIS- Related Activities

1. The Basle Committee on Banking Supervision (BCBS);
2. The Joint Forum on Financial Conglomerates
3. Committee on the Global Financial System (CGFS).
4. Committee on Payment and Settlement Systems (CPSS);
5. Committee on Interbank Netting Schemes

B. Other

IV. Relationship Between BIS Rules and National Financial Authorities

V. Need For International Bank.

VI. Proposals that The Bank For International Settlements Become World Financial Authority

VII. Proper Development of a WFA

VIII. Conclusion

CHAPTER I

Introduction

Negotiations to create the Bank for International Settlements (“BIS”), the oldest of the

large international banks, were begun in Paris in 1929.¹ It was perceived then as an institution very different from today's reconstituted BIS. In 1932, when less than three years old, a book about BIS began:

In March 1929, almost to a day two hundred years after the death of John Law, and within a few hundred yards of the scene of his activities, the scheme of a bold experiment, worthy of the genius of that financier, was elaborated in Paris by a body of distinguished experts. It was pregnant with immense possibilities, but also with great dangers. It was as ambitious and as perilous as was John Law's scheme for a bank of issue in the less advanced conditions of eighteenth-century France.

The world was taken by surprise when it was announced that the Committee of Experts on Reparations had decided to propose the establishment of an International Bank. The novelty and boldness of the idea appeared fascinating to some people, bewildering to others. ... The Bank for International Settlements is not designed as a superior authority over central banks ... No legal or political power, but the recognition of the necessity to co-operate and the development of a strong public feeling against the disturbers of harmony are the main factors (which the Bank depends upon) for its existence.²

¹ The Bank for International Settlements and the Basle Meetings, Basle, May 1980, p.9.

² Einzig, "The Bank for International Settlements," Third Ed. (MacMillan 1932) pp.1, 4 and 5.

In 2002, as a testament to its growth and development, it was written: “The BIS is without a peer in what it has accomplished.”³

As further tribute to its success, some 70 years after the creation of BIS, the world financial system and BIS itself had sufficiently evolved that the bank with “(N)o legal or political power” was being nominated “to perform in the domain of world financial markets what national regulators do in domestic markets.”⁴ It is the goal of this article to trace that evolution and show how BIS - and, as we shall soon see, its affiliates in Basle, Switzerland - won that nomination.⁵ We will also recommend that efforts to appoint it/them the supreme international regulator not be pursued. While we believe that there is legitimate need for this office, we do not believe that BIS or its affiliated organizations should be supported for this role. At least not now.

BIS functioned as a significant part of the world’s banking systems in its evolution from its dubious creation in 1929 to its position as nominee for the world’s senior financial regulator in 2000. From the start modesty was not its prime virtue and it perceived itself as a major cog in the international financial system. In 1931 it assisted in control of an international monetary crisis that was marked by massive withdrawals of capital from the worst hit countries. The great

³ Baker, James C. “The Bank for International Settlements, Evolution and Evaluation,” (Quorum 2002), xii.

⁴ Eatwell and Taylor, “Global Financial Risk,” (New Press 2000), p.x.

⁵ As we will soon see *infra* in Chapter III, it may be BIS and it may be the Committee on Banking Supervision established at BIS that is in reality the candidate for this global role. Eatwell and Taylor, *infra*, note 4, speak of “the foundations of global financial surveillance and regulation that have already been laid at the Bank for International Settlements in Basle.”

depression of the 1930s saw BIS involved with such major issues as the proper place for exchange controls and the function of the gold standard in dealing with international dislocations. BIS participated in the discussion of stabilization efforts at the 1933 London Monetary and Economic Conference and had contributed to their partial inclusion in the Tripartite Agreement among the United States, England and France in 1936.

The worsening of the political situation in Europe in the late 1930s prevented further initiatives; World War II temporarily ended the role of BIS in international regulatory activities although it achieved a unique place in world at war in both financial dealings and reporting. Upon the end of the war, concepts for a new world financial order were largely concentrated in the Bretton Woods (New Hampshire) Conference held in July 1944. It was generally assumed that international financial affairs would be centered in the newly-created International Monetary Fund to be based in Washington D.C., far from BIS. The Bretton Woods final declaration consequently contained a resolution that BIS be liquidated.

The resolution was never carried out because BIS almost immediately assumed a major and central role in the post-war international payment systems. BIS was and is a bank and from its creation it performed the functions of a bank. As noted, the principal reason for its creation was the German reparations issue and it assisted - in part as a direct lender to Germany - in providing the funds for those payments. It also acted as depository bank for countries that received reparations and suddenly had surplus reserves and also as a general depository entirely apart from reparations. Within a year after its creation, BIS had just under 1,800 million gold

francs in deposits of which 800 million were unconnected with reparation payments.

BIS also served a kind of regulatory/supervisory function by providing a forum for the world's central banks in their efforts to effectuate, first, the goals of Bretton Woods and later in their bank management functions. BIS was created to be not a central bank, but a bank for central banks⁶. The dominant function of central banks has always been fiscal control, oversight of the money supply. Whether central banks should simultaneously act as a regulator of the local banking system has been and continues a bone of contention with different countries going in different directions. A recent article surveys thirty countries and concludes that ten give their central banks regulatory responsibilities and twenty do not.⁷ Clearly, the United States has taken a strong pro-regulatory position since its Federal Reserve System (the U.S. central bank) does regulate a major share of the American financial system including national banks and all bank holding companies. England has gone the other way with the Central Bank of England performing regulatory functions until they were taken away in 1997 and given to the newly formed Securities and Investment Board (now Financial Services Authority). It was not unnatural that BIS should drift into regulatory activities.

BIS's Bretton Woods work after World War II led in turn to the reconstruction of the European economy and with ongoing attempts to remove trade and foreign exchange barriers

⁶ In 2000, BIS had 49 central bank members; at the June 2000 Annual Meeting in Basle, 99 central banks attended with governors from 76 central banks. Baker, *supra*, note 2, p. 240.

⁷ Schooner, *The Role of Central Banks in Bank Supervision in The United States and The United Kingdom*, Bkly.J.I.L., 411, 417-422 (2003).

within Western Europe. The most significant outcome of these developments was the creation in 1950 of the eminently successful European Payments Union (“EPU”), with BIS as a core participant in its planning. The major object of EPU was to eliminate payments barriers within Europe and enable full transferability as an adjunct to the creation of free trade. Within the operation of the new EPU, surpluses and deficits among trading partners was largely netted and settled in terms of net credits; this meant that, compared to the earlier trading system, comparatively little had to be settled in the international media of dollars and gold. Gradually, full dollar settlement was made possible and full convertibility within not only Europe but with the United States became a reality. BIS was the agency chosen as the central clearing house for this new and complex system..

The 1960s and early 1970s were periods of serious turmoil in the international financial markets. Among key events were the collapse of the Bretton Woods fixed exchange system that could not accommodate the needs of international trade. In its place there developed a system known as “managed floating ” which recognized acceptable exchange rates but permitted their flexibility within certain bands. Difficulties were compounded by the creation of OPEC and the resulting worldwide rise in oil prices accompanied by new and unprecedented financial surpluses in the middle eastern oil producing countries. These had to be recycled, a process that required the cooperation of the International Monetary Fund, the major international banks and BIS. It was only the existence and efficiency of a suitable international market that made this possible and it was through BIS that the world’s central banks were able to communicate.

Increasingly during its decades of growth, the banking activities of BIS meshed with its evolving function of international bank regulator. It was initially perceived as a place where central banks could conveniently meet and share their problems. As a bank, however, it also actively participated in solving those problems. For example, BIS was itself a borrower; it received money both in the form of deposits and as direct loans from institutions with surplus funds.⁸ When informed by central banks that a local bank was overly liquid, BIS would arrange to borrow from that institution; i.e. “to siphon off liquidity viewed as excessive by the central bank concerned.”⁹ In its various contacts with the central banks, BIS was never too far from a role as bank regulator.

At the end of 1974, BIS participated in an act that turned out to be its most consequential step in the direction of international bank regulation: it cooperated with the central bank governors of the Group of Ten countries and Switzerland to set up what was originally called the Committee on Banking Regulation and Supervisory Practices. (The name was later changed to its current name, the Committee on Banking Supervision (“CBS”).) As will be discussed below,¹⁰ CBS is not formally a unit of BIS, but it functions and is widely accepted as one. Its creation resulted both from a continuing association of central banks on the international stage and, more near-term, from a series of international banking disturbances including: the fourfold

⁸ BIS received both deposits and loans from oil-producing countries who benefitted from rises in oil prices.

⁹ The Bank for International Settlements and the Basle Meetings, Basle, May 1990, p.35.

¹⁰ See Chapter III, note (second footnote).

increase in petroleum prices; a wide fluctuation in interest rates that reached record highs in mid-1974; an international depression that deepened in 1974; the removal in January 1974 of U.S. controls on capital outflows; and the Herstatt Bank failure that is still cited to illustrate systemic bank risks.¹¹

BIS, CBS and various related committees (such as the Joint Forum on Financial Conglomerates), that will be dealt with together in Chapter III form a kind of amorphous international conglomerate of bank regulators. When BIS and/or the other groups are mentioned as a potential world financial authority, it is really this body that is being referenced. We will at appropriate times single out the particular committee that is at work on a particular project and, to some degree, accuracy is enhanced in this way. At the same time, we see the forest better if we downpeddle the trees and deal with the group as a whole. If a world regulator is ultimately appointed, it will be distilled from this entire group and we are in fact seeing things correctly when we consider international bank regulation as the task of this group. The group has evolved in a consistent manner.

At its formation in 1974, CBS did not attempt to regulate international banking. Rather, it attended to “broad supervisory standards and guidelines.”¹² Peter Cooke, Director of Supervision of the Bank of England, and in 1984 chairman of CBS, described its role at that time as follows:

¹¹ All of these events are mentioned in 61 Fed,Res.Bul. 606 (1975).

¹² BIS web; bis.org/forum/index.htm.

The committee does not undertake a formal supernational supervisory role ... [I]t formulates and recommends broad supervisory principles and guidelines of best practices in the hope and expectation that individual authorities will take steps to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems.¹³

A marked change occurred in 1988 with the issue by CBS of the Basle Accord on Capital Adequacy.¹⁴

[T]he capital agreement marked a quantum leap for the Committee's role as a joint decision-making body. Previously, the Committee's role had been largely a forum for the exchange of information, and a place where supervisors could learn from each other and develop codes of best practice [T]he capital agreement went much further. ... Although not legally enforceable as a treaty, and although the Committee is not a formally constituted international organization, nonetheless the agreement is considered to be binding on the members and the agreement itself states that the Committee will continually monitor its application.¹⁵

CBS's stature as an international bank regulator was enhanced in 1991, three years after

¹³ From Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities*, 49 Ohio St.L.J. 1299, 1337 (1989).

¹⁴ See *infra* Chapter 3.

¹⁵ Hayward, *Prospects for International Cooperation by Bank Supervisorw*, 24 Int.Lwr. 787, 790 (1990).

its issue of the capital agreement, by the appointment of Gerald Corrigan, President of the Federal Reserve Bank of New York as its chairman. The Financial Times¹⁶ described Mr. Corrigan as “the leading U.S. spokesman on supervision issues” and confirmed that his appointment “will add considerable stature to“ CBS. The selection not only added generally to the stature of CBS but highlighted its role as a nascent international bank regulator.¹⁷

The life of BIS and its related companies can be divided into four phases:

1. From its creation to 1988 it undertook banking functions and opined generally on the international banking system.

2. Starting in 1988 it began to assume the role of an unofficial international bank regulator. Although it had no official international status, its members - central banks of the major banking countries - were obligated by the nature of their membership to abide by its edicts and the rest of the world took them seriously.

3. Starting in the late 1990s, it began to consider itself the equivalent of an international bank regulator. Every subject of significance was within its jurisdiction and, although its legal powers were no greater, it assumed that it had a right to make rules for local banks to observe in

¹⁶ July 9, 1991.

¹⁷ Discussed generally in Golembe, The Golembe Reports, 1991-6. Mr. Golembe writes at page 11:

We can only guess at who all of the players were and what motivated them. My guess is that when that story is finally written it will turn out that the U.S. regulators played a major role in boot-strapping the Basle Committee to its present position of eminence, probably with a great deal of assistance from the Bank of England. And among the U.S. agencies, the Federal Reserve Board probably deserves the most credit or blame, depending upon one’s assessment of what has been accomplished.

the conduct of their businesses.

4. Some time in the future there is a widespread anticipation that it will be given through some treaty mechanism the power to enforce its rules internationally.

Chapter II of this article gives a fuller picture of BIS and its place in the international banking system. Chapter III describes the place of BIS, largely through CBS, in bank regulation, the operation that led to the consideration of BIS/ CBS as the international bank regulator. In Chapter IV we show how the role of bank regulator is being assumed by BIS/CBS through the adoption of its proposals by the major banking systems of the world. Chapter V describes the international banking system and the needs for a senior regulator and Chapter VI gives the arguments that make BIS/CBS a logical candidate for that position. Chapter VII gives the position of the authors that BIS/CBS should not now be formally nominated for the position. The article and our conclusions are summarized in Chapter VIII.

CHAPTER II

Profile of the Bank for International Settlements

Today, BIS stands tall as the world's oldest international financial institution, remaining as the principal center for maintaining stability in the international central banking cooperation among central banks.¹⁸

¹⁸ For more information about the BIS, go to <http://www.bis.org/about/index.htm>.

BIS, formally created on January 20, 1930, at the Hague Conference with the main purpose of implementing Germany's reparation (settlement) payments to victorious Allied nations.¹⁹ The newly established bank was to take over the functions previously performed by the Agent General for Reparations in Berlin, Germany, which included collection, administration and distribution of the annuities payable as reparations. This is also why the bank was named a bank “for international settlements.”

The reparation payments were to be paid into the BIS in German currency and would serve as collateral for a hard-currency bond-issue to be provided by the French government. Nothing came of the bond issue because of the Great Depression's impact on the world economy before BIS commenced its activity.

In addition to its role in Germany's reparation payments, BIS was also created to act as a trustee for international loans issued to finance reparations (often called “Young Plan” or “Dawes Plan”), to promote central bank cooperation and to facilitate operations of international financial activities.²⁰ Exactly how the BIS founders were to promote central bank cooperation was unclear at the time. Nevertheless, the financial crises of late 1920's and early 1930's may have led central bankers to believe that a central financial institution was required in order to coordinate efforts of

¹⁹ See the The Hague Convention for creation of the Bank for International Settlements, January 20, 1930. On June 10, 1930, the Hague Convention was prolonged for the existence of the BIS.

²⁰ See James C. Baker, “The Bank for International Settlements, Evolution and Evaluation,” Quorum Books, 2002.

central bankers and financial regulatory authorities in preventing future financial crises.

Basle,²¹ a city located in Switzerland, was chosen as the bank's headquarters.²² In addition, the bank had two representative offices, one located in the Hong Kong Special Administrative Region of the People's Republic of China²³ and the other in Mexico City,²⁴ which facilitate the bank's operational activities for Asia and the Pacific, as well as for the Americas, respectively.²⁵ The bank was initially funded by the central banks of its founding countries: France, Germany, Belgium, Italy, Japan²⁶ and the United Kingdom,

BIS was created as a commercial bank and adopted the legal structure of a Swiss limited company with publicly held shares. The BIS is subject to neither to the Swiss banking nor

²¹ We intend to use the American style spelling of the city in which the BIS is located. Europeans and other countries commonly spell it as "Basle."

²² Switzerland might have been chosen because of its tradition as a neutral country.

²³ See "Host Country Agreement Between the Bank for International Settlements and the Government of the People's Republic of China Relating to the Establishment and Status of a Representative Office of the Bank for International Settlements in the Hong Kong Special Administrative Region of the People's Republic of China" of May 11, 1998. For a complete text, go to <http://www.bis.org/about/hostctryhk.htm>.

²⁴ See "Host Country Agreement Between the Bank for International Settlements and the United Mexican States Relating to the Establishment and Status of a Representative Office of the Bank for International Settlements in Mexico." For a complete text, go to <http://www.bis.org/about/hostctrymx.htm>.

²⁵ The bank has not yet established any representative office for Africa or the Middle East. Regardless of the bank's failure to establish its presence in these regions, some central banks there have already started to implement the bank's directives.

²⁶ Based on an announcement made by the Swiss government on December 26, 1952, Japan renounced all rights, titles and interests under the Convention.

corporate laws. The Bank's immunity from Swiss government interference and taxes in both peace and war was guaranteed by the Hague Conference, which established the BIS as an international organization governed by international law with the privileges and immunities necessary for the performance of its role.²⁷

The international legal personality of the BIS and the privileges and immunities which it has enjoyed in Switzerland since its founding were also "reconfirmed" in other documents such as The Brussels Protocol of July 30, 1936²⁸ and the Headquarters Agreement (entered between the BIS and the Swiss government on February 10, 1987.²⁹) It is apparent from these documents that the BIS has a legal status in Switzerland similar to that accorded to the many other international organizations which have been established there since 1930.

According to BIS's first annual report, its total assets as of March 31, 1931 were 1,901,148,912.91 in Swiss gold francs.³⁰ Today the gold franc of the BIS weights just over 0.29 grams, identical with the gold parity of the Swiss franc at the time of BIS' founding in 1930. In

²⁷ See Article 1 of the Hague Convention of 1930.

²⁸ See The Brussels Protocol of July 30, 1936, at <http://www.bis.org/about/protoc.pdf>.

²⁹ See The Agreement of February 10, 1987, between the Swiss Federal Council and the Bank for International Settlements to determine the Bank's legal status in Switzerland. For an extract of the Agreement, go to <http://www.bis.org/about/hq-ex.htm>.

³⁰ See Baker, *supra*, at page 15.

September 1936, by which time number of leading countries had left the gold standard, the gold parity of the Swiss franc was suspended. The BIS employs the gold franc solely for balance-sheet purposes in order to convert assets and liabilities expressed in US dollars into gold francs at the fixed rate of USD208 per ounce of fine gold (equivalent to 1 gold franc = USD 1.94) All other currencies are converted into gold francs based on their market rates against the US dollar.³¹

When the Bank's initial capital was raised, the subscribing institutions were given the option of taking up the whole of their allocated shares or arranging for those shares to be subscribed to by the public. As a result, part of the Belgian and French issues and the whole of the American issue are not held by the institutions to which they were originally allocated. In all, some 86% of the Bank's issued share capital is registered in the names of central banks, the remaining 14% is held by private shareholders. While all shares carry equal rights with respect to the annual dividend, private shareholders have no right to attend or vote at General Meetings of the BIS, since all rights of voting and representation are reserved for the central bank of the country in which the relevant national issue of shares was initially subscribed.³²

As of March 31, 2003, the BIS balance sheet showed total assets of 92.8 billion gold francs with capital and reserves of 5.5 billion gold francs.³³ These assets are held in gold, cash, treasury bills, time deposits and advances in currencies, securities purchased under resale

³¹ *Id.*, at page 10.

³² See Kristin K. Howell, "Regional and International Cooperation and Monetary Stability: The Roles of the International Monetary Fund and the Bank for International Settlements," 1992, *Rivista Internazionale di Scienze Economiche e Commerciali* 39 (10-11): 833-848.

³³ See the BIS Balance Sheet as of March 31, 2003, at <http://www.bis.org/banking/e-balancesheet.pdf>.

agreements, government and other securities at term, land/buildings and equipment and miscellaneous assets.³⁴ In terms of the market price of gold at that time, BIS total assets were USD180 billion and its capital and reserves amounted to USD10.6 billion.³⁵ Regardless of these numbers, the true value of the bank is uncertain. There could be other assets, among them tracts of valuable land around Basle, which do not appear on BIS' balance sheet.³⁶

A majority of BIS shareholders and members are still the central banks (comprising almost 86 percent of the bank's issued shares capital), which originally purchased its shares, and what remains of the original US bank syndicate. Several central banks, including those of France, Belgium and Denmark, along with the US syndicate of private banks, have sold substantial portions of their holdings to the public. But only central banks) can vote.³⁷ The private shareholders do not have a right to attend, or to vote at, the BIS' general meetings.

Although all its depositors are central banks, the BIS has consistently operated at a profit. And because it has been highly profitable, it has not required a subsidy or any kind of aid from any government. Because the BIS provided a safe and convenient depository for the gold holdings of the European central banks, the BIS quickly evolved into the bank for central banks. As the world depression deepened in the '30s and financial panics flared up in Austria, Hungary, Yugoslavia, and Germany, the governors in charge of the key central banks feared that the entire

³⁴ See *id.*

³⁵ The exchange rate used at that date was 1 gold franc equal to \$1.94 and the price of gold used for these calculations was a fixed rate of \$208 per ounce of fine gold

³⁶ The Oxford Group, established in 1987, it is an international consulting and training organization, working on all the people dimensions of business. We are proud to list many blue chip companies amongst our clients.

³⁷ See Alexandre Lamfalussy, *supra id.*

global financial system would collapse unless they closely coordinated their rescue efforts. The obvious meeting place for this desperately needed coordination started in the BIS, where gold swap transactions and war-damage settlements were regularly arranged.

The BIS's central mission of reparations payments concluded sometime around 1932.

During World War II, when nations battled, their central banks maintained their business activities. The BIS was thus able to continue operating in Basle, though the monthly meetings were temporarily suspended. In 1944, following Czech accusations that the BIS was laundering gold that the Nazis had stolen from occupied Europe, the US government supported a resolution at the Bretton Woods Conference (1944) calling for the liquidation of the BIS. The naive idea was that settlement and money-clearing functions that the Bank was providing could be taken over by the new international financial institution, the International Monetary Fund. Although the Bretton Woods Conference considered liquidation of the BIS it did not make any decision on the Bank's fate.

What could not be replaced was what existed behind the mask of an international clearing house: a supranational organization for setting and implementing global monetary strategy. These leadership positions simply could not be accomplished by a democratic U.N.- like international agency. The central bankers, not about to let their club be snatched away from them, quietly let the US resolution die. Instead of "going out of business," the BIS gained more

authority, particularly in arranging financial transactions to preserve the stability of international financial markets.³⁸

So, the BIS reemerged as the main clearing house for European currencies and, behind the scenes, as the favored meeting place of central bankers. When the dollar came under attack in the 1960s, massive swaps of money and gold were arranged at the BIS to bolster the U.S. currency. It was ironic that, as the then president of the BIS observed, “the United States, which had wanted to kill the BIS, suddenly finds it indispensable.”³⁹

Since 1930, central bank cooperation at the BIS has taken place through the regular meetings in Basle of central bank governors and experts from central banks and other national financial regulatory agencies. In support, the Bank has developed its own research in financial and monetary economics and makes important contributions to the collection, compilation and dissemination of economic and financial statistics.

The BIS has also provided or organized emergency financing to support the international

³⁸ The Bank, besides ensuring its survival, also maintained its original name, the “Bank for International Settlements,” although the mission of the German “settlement” payments process had ended. Perhaps this was a tactical strategy designed to give the international community an impression that the bank was still facilitating its “settlement” payments function, avoiding, therefore, any protest from the community, already sensitive to the bank’s murky transactions during the Nazi period.

³⁹ See Edward Jay Epstein, “Ruling the World of Money,” *Harpers Magazine*, 1983.

monetary system when needed. During the 1931-33 financial crisis, the BIS organized support credits for both the Austrian and German central banks. In the 1960s, the BIS arranged special support credits for the Italian lira (1964) and the French franc (1968), and two so-called Group Arrangements (1966 and 1968) to support sterling.

In the monetary policy field, cooperation at the BIS in the immediate aftermath of the Second World War and until the early 1970s focused on implementing and defending the Bretton Woods system. Thereafter, during the 1970s and 1980s, the focus was on managing cross-border capital flow transactions following the oil crisis and then the international debt crisis. More recently, the BIS provided finance to the IMF-led stabilization programs for the default loans of Mexico in 1982, and Brazil in 1998, the 1997 Asian crisis and more.

All the above crises as well as the issue of financial stability in the wake of economic integration and globalization, have received considerable attention in the international banking community, bringing the issue of regulatory supervision of internationally active banks to the attention of the BIS, which resulted in the 1988 Basle Capital Accord and its “Basle II” revision of 2001.

Apart from fostering monetary policy cooperation, the BIS has always performed “traditional” banking functions for the central bank community (for example, gold and foreign exchange transactions), as well as serving trustee and agency functions. The BIS was the agent

for the European Payments Union (1950-58), providing assistance in restoring the convertibility of European currencies after the Second World War. Similarly, the BIS acted as the agent for various European exchange rate arrangements, including the European Monetary System (1979-94), which preceded the move to a single currency, the Euro.

Even though an isolationist U.S. Congress officially refused to allow the U.S. Federal Reserve Board (“FRB”) to participate in the BIS⁴⁰ or to accept shares in it (which were instead held in trust by the First National City Bank), the chairman of the FRB quietly and frequently attended important meetings at the Bank’s headquarters. Evidently, world monetary policy was too important for the chairman to leave to national politicians.

The fact that the first president appointed to the BIS (1930-1935) was an American banker, Gates W. McGarrah (formerly of Chase National Bank & the U.S. Federal Reserve Bank), shows that by 1930, the U.S. was a financial force on the international scene.⁴¹ In the 1940-1946 period, the BIS Board of Directors elected another American banker, Thomas H. McKittrick, as president of the Bank, and at General Meetings of the Bank, it has always appointed a New York bank to exercise the voting rights carried by the shares of the American issue. In addition, close personal contact is regularly maintained between the principal BIS

⁴⁰ The Federal Reserve Board has become a leading member of the BIS, before and after its formal representation in the BIS Board of Directors in 1994. Either then-Chairman Paul Volcker or Governor Henry Wallich attended almost every “*Basle weekend*” meeting.

⁴¹ See Anthony Sampson "The Money Lenders" (Hodder & Stoughton '81)

officials and officers of the FRS. The Federal Reserve Bank of New York is the Bank's correspondent to the U.S. market.⁴²

No American official served as a director or alternate director of the BIS until 1994.⁴³ Then, at its meeting on July 12, 1994 the Board of Directors of the BIS took note of, and welcomed, the intention of the FRB to occupy the two seats on the Board of Directors to which the FRB had been entitled since 1930. An Extraordinary General Meeting of the Bank was convened on September 13, 1994 to approve a minor change in the Statutes of the Bank, taking account of the evolution of the Federal Reserve System to its present structure. Alan Greenspan, Chairman of the FRB, became an ex-officio member of the Board of Directors of the Bank on September 13, 1994. The Board also appointed William J. McDonough, then President of the Federal Reserve Bank of New York, as a member of the Board for a period of three years beginning September 13, 1994.⁴⁴

The fact that the FRB formally joined the BIS went almost unnoticed in the U.S. banking and financial community, with the exception of a few dozen U.S. banking expert. There were no

⁴² See Charles J. Siegman, "The Bank for International Settlements and the Federal Reserve," published in the Federal Reserve Bulletin for October 1994.

⁴³ See the Bank's 65th Annual Report (pp. 205-206) for the fiscal year ending March 31, 1995.

⁴⁴ See Reginald H. Howe, "Bank for International Settlements [a/k/a Bank for Intervention and Subversion] Memo on Freeze-Out of Private Shareholders," Gold Ant-Trust Action Committee, October 27, 2000.

U.S. Congressional hearings nor was there any public statement by the U.S. President or its Secretary of State. Not until 1995, almost a year later, did The New York Times report that the FRB had “joined” the BIS which was interestingly enough characterized as an “obscure global bank [which] moves into the light.”⁴⁵

Since its inception, the relationships between the BIS and European central bankers has gradually developed to the extent that sometimes the bank is regarded as a “European” bank. Until 1994, the BIS did function as the principal organization for cooperation among Europe's major central banks, of which several were and remain friendly toward gold. But with the signing of the Treaty of Maastricht (1993) and the creation of the European Monetary Institute (1994), a predecessor organization to the European Central Bank, the BIS has faced the prospect of playing a rapidly reducing role in European monetary affairs.

Observers feared that the creation of a unified European financial institution would jeopardize the future role of BIS. However, the Bank was quick to assure bankers otherwise. For example, in 1994, when Baron Alexandre Lamfalussy resigned from his post as General Manager of the BIS in order to become Head of the European Monetary Institute, Andrew Crockett, who was replacing Lamfalussy as General Manager said he “did not foresee the EMI [European Monetary Institute] . . . impinging on the work of the Basle-based BIS which is widely regarded as the central banker's central bank,” adding that “the EMI would enable the BIS to re-

⁴⁵ See K. Bradsher, “*Obscure Global Bank Moves Into the Light*,” The New York Times, August 5, 1995, Business, p. 1.

focus on global issues, and develop its role as a forum for collaboration between central banks in the monetary and regulatory fields.”⁴⁶

It may have been a coincidence, perhaps a well-coordinated step, that at the time the BIS’ role towards European monetary affairs was diminished because European central bankers were focusing on the creation of their European Central Bank, the FRB decided to join the BIS. The FRB may have felt that it was the right time to fill the vacuum created in the Bank’s role.

Since its inception, the BIS established a remarkable pattern of secrecy. Central bankers sought complete anonymity for their activities. They comprised the BIS membership and met monthly to discuss matters of relevance to economic and banking policy. The success of the organization derived from the secrecy of its meetings and the trust created among central bankers through their discussions at their frequent meetings. The BIS’s headquarters were in an abandoned six-story hotel, the Grand Hotel et Savoy Hotel Unives,⁴⁷ with an annex above the adjacent Frey’s Chocolate Shop.⁴⁸ There purposely was no sign over the door identifying the BIS so visiting central bankers and gold dealers used Frey’s, which was across the street from the railroad station, as a convenient landmark. It was in the wood-paneled rooms above the shop and in the hotel that decisions were reached to devalue or defend currencies, to fix the price of gold,

⁴⁶ See The Times of November 10, 1993.

⁴⁷ The building which was formerly the Grand Hotel et Savoy Hotel Unives at Centralbahnstrasse 7, Basle, and a series of adjacent buildings taken over either wholly or partially where the Bank had its seat from 1930 to 1977.

⁴⁸ The BIS purchased a new office building constructed at Centralbahnplatz 2, Basle, to which the Bank moved in 1977. In addition, the Bank built a sport center in Kreuzackerweg, Bottmingen (Canton of Baselland) which was inaugurated in 1972.

to regulate offshore banking, and to raise or lower short-term interest rates. Though they sought to shape a new world economic order through these deliberations the public remained almost totally unaware of the club and its activities.⁴⁹

In May 1977, however, the BIS gave up its anonymity, against the better judgement of some of its members, in exchange for more efficient headquarters. The new building, an eighteen-story-high circular skyscraper that rises over Basle like some misplaced nuclear reactor, quickly became known as the “Tower of Basle” and began attracting attention from tourists. “That was the last thing we wanted,” said Dr. Fritz Leutwiler, former president of the BIS, describing tourist attention to the bank. In reference to the location of the bank, he added that, “If it had been up to me, it never would have been built [here].”⁵⁰

Despite its irksome visibility, inside, the bank does have the advantages of luxurious space and high efficiency. The building is entirely air-conditioned and self-contained with its own nuclear-bomb shelter in the sub-basement, a high-tech fire-extinguishing system (so outside firemen should never have to be called in), a private hospital, and an endless subterranean archive system. The top floor is a restaurant, which is used to serve the members of the Bank only. The next three floors down are suites of offices reserved for the central bankers. The BIS computer, which is directly linked to the computers of the member central banks, and provides instantaneous access to data about the global monetary situation is located on the lower floors

⁴⁹ See “The Bank for International Settlements and the Basle Meetings,” published on the occasion of the fiftieth anniversary (1930-1980), May 1980.

⁵⁰ See Edward Jay Epstein, “Ruling the World of Money,” *Harpers Magazine*, 1983.

along with the actual bank, where a dozen traders and gold traders carry out their financial transactions on behalf of the Bank. “We try to provide a complete clubhouse for central bankers ... a home away from home,” said Gunther Schleiminger, the former general manager of the Bank.⁵¹

The BIS earned an unenviable reputation for its readiness to serve the Nazi regime. In 1938, when Hitler marched into Prague, the BIS practically fell over in its rush to surrender the gold the Czechoslovakian government had left with the Bank for safekeeping.⁵² Two other examples of the BIS’ bias can be noted:

First, the BIS arranged the transfer of USD378 million of what was, in effect, gold looted from the coffers of the invaded countries of Austria, Czechoslovakia, Holland and Belgium into the account of the German Reichbank.

Second, in 1942, plans for the projected U.S. invasion of Algeria were leaked to the governor of the French National Bank, who then immediately contacted his German colleague in the BIS (SS Gruppenfuehrer Baron Kurt von Schroder of the Stein Bank of Cologne), and by transferring 9 billion gold francs to Algiers - via the BIS - the Germans and their French

⁵¹ See id.

⁵² See Glyn Davis "A History of Money" (University of Wales '94)

subsidiaries made a killing of some USD175 million in this US dollar exchange scam.⁵³

BIS has always tried to keep a low profile with respect to its activity during the Nazi regime. As the former general manager of the BIS, Andrew Crockett, said on the subject, “It is fair to say our [the bank’s] original focus has been to establish facts rather than to try to guess the motivations and opinions' of the wartime management.”⁵⁴

In the face of its accomplishments, the BIS continues to stand in the shadow of its past controversial role in laundering Nazi gold in the late 1930s and early 1940s. However, while it is asserted that the BIS entered into unlawful transactions in gold during the Nazi period, there is little historical documentation presented to support the argument.⁵⁵ It remains the duty of historians to uncover the historical truth of this dark period in the activity of the Bank.

⁵³ See Charles Higham, “Trading With the Enemy: An Expose of the Nazi-American Money Plot, 1933-1949,” Doubleday, December 1982.

⁵⁴ See Allan Cowell, “Global Central Bank Says It Held Gold Looted by Nazis,” *The New York Times*, May 13, 1997.

⁵⁵ One of the major problems for not having enough historical documentation has been the fact that the BIS did not open its archives until the 1990s. Under the BIS open archive rules, all records relating to the Bank's business and operational activities which are over 30 years old are available for consultation, with the exception of a very limited number of records that remain private or confidential even after 30 years have elapsed.

See James C. Baker, “*The Bank for International Settlements: Evolution and Evaluation*,” published by EH.NET (July 2003).

Central banks regularly transfer deposits to the BIS. By commingling part of their reserves in what amounts to large blocks of mutual funds of short-term investments, the central banks create a convenient screen behind which they can “conceal” their own deposits and withdrawals in financial centers around the world. For example, if the BIS places funds in France, central banks do not have to answer to their respective governments for investing in France. Central banks are perceived to pay high fees to use such transactional services from the BIS. It becomes apparent that, regardless of its name, the BIS is far more than - or perhaps different from - a bank. As described above, from the outside the Bank appears to be a small, technical organization. Only 86 of its 298 employees are classified as professional staff. The bank is not a monolithic institution artfully concealed within the name of an international bank but rather it is like a series of Chinese boxes one inside another containing the true departments and services the central bankers need and pay to support.

The BIS emerged over time as a major international organization charged with the task of increasing the efficiency of regulatory and supervisory activities for improvement of the international banking system. The Bank ultimately claimed a major place in world financial affairs. It became part of the international cooperative effort post-1945, ensuring the stability of the international financial system.

During the 1960s, the Bank started to analyze international financial markets, including the new Euro currency markets, and developed new databases on international capital and

currency stocks and flows. During the 1970s, the Bank started to study potential country risk in developing economies. It was among the first financial institutions to warn of the possibility of a sovereign debt crisis in loan default matters. The independence of central banks from their respective governments, a goal sought by most central banks reflects the image of the BIS which has a most ambiguous background from the other international financial institutions.

BIS confirms the firm belief of most of its members that central banks should act independently of their home governments. The bank holds extensive discussions with central bankers, encouraging them to remain as independent in their activities as possible. This independence is visible in the Bundesbank (Central Bank of Germany), whose president is not required to consult with government officials or answer the questions of German Parliament, even about such critical issues as raising interest rates. The Bundesbank President even has refused to fly to Basle in a government plane, preferring instead to drive in his Mercedes limousine.

In order to safeguard the Bank's independence, a director of the BIS can not be an official of a government or a member of a legislative body, unless he is the governor of the central bank. It is precisely this provision which gives the Bank its characteristic as a central bankers' club, and its resistance against the intrusion of government officials.⁵⁶ When Dr. Leutwiler became president of the BIS in 1982, he insisted that no government official be

⁵⁶ See Henry H. Schloss, *id. supra*.

allowed to visit during a “Basle weekend.” He recalled that in 1968, U.S. Treasury undersecretary Fred Deming had been in Basle and stopped in at the Bank. “When word got around that an U.S. Treasury official was at the BIS,” Leutwiler said, “bullion traders, speculating that the U.S. was about to sell its gold, began a panic in the market.”⁵⁷

Further, the Bank shares a strong preference for pragmatism and flexibility over any economic ideology. Rather than resorting to rhetoric and invoking principles, the Bank searches for any remedy that will relieve a potential financial crisis. For example, in the external debt rescheduling of Brazil in 1993, Peru in 1997, and Cote d’Ivoire in 1998, the Bank stepped up its efforts, acting as an agent for these debt rescheduling. In late 1980’s, when Brazil defaulted on its loan payments, the Bank loaned monies, which were guaranteed by the Bank’s central bank members. In this case, the bank quietly decided to extend the deadline instead of collecting the money from guarantors. As one former high official of the Bank summed it up, “we [the Bank] are constantly engaged in a balancing act, without a safety net”.⁵⁸

Fundamentally, the most important belief of the Bank is its conviction that when the bell tolls for any central bank it also tolls for them all. For instance, in the Mexican default crisis of 1982, the issue for the BIS was not the welfare of Mexico but the stability of the entire banking

⁵⁷ See Edward Jay Epstein, “Ruling the World of Money,” *Harpers Magazine*, 1983.

⁵⁸ See *id.*

system and its central banks. Mexico had been constantly borrowing overnight funds from the interbank market in New York to pay the interest on its USD80 billion external debt. Each time, Mexico had to borrow more money to repay the interest on the previous transactions, and in a couple of months, it had borrowed nearly one quarter of all the “Fed Funds” (a banker’s term for loans between banks). The FRB found this an emergency situation requiring its interference and asked the BIS to take a leading role in the escalating situation. The BIS realized that Mexico’s entire financial system was a time bomb, and in less than 48 hours, the BIS responded to the Mexican central bank’s desperate need to get out of the interbank market by arranging a temporary bridging loan of USD1.85 billion. While money for this loan appeared, in the press, to have come from the BIS, almost all the funds came from the central banks which are part of the Bank, including the FRB, the Bundesbank, Swiss National Bank, Bank of England, Bank of Italy, and Bank of Japan. The BIS undertook virtually no risk in this rescue operation but rather coordinated assistance among central banks. The central banks’ efforts to rescue one of their own (the Mexican central bank), avoided potential spread of the financial crises.⁵⁹

However, the bailout of Mexico was only a temporary victory for the BIS. Other countries, including Argentina, Chile, Venezuela, Brazil, the Philippines and Russia, have faced similar default situations, and the BIS has repeated its role as a crises manager.⁶⁰

⁵⁹ See “U.S. Banks Eye Foreign Crisis’ Link to Lending,” *American Banker*, June 12, 1997.

⁶⁰ See “Lenses of Last Resort,” *The Economist*, June 6, 1998.

Financial interventions from the BIS have created considerable concern among critics who do not share the Bank's philosophy. Some of these critics prefer that the FRB, instead of the BIS, worry about financial crises such as Brazil and the rest of Latin America. Others have argued that the Bank does not have the experience or facilities to become a sort of IMF, extinguishing financial crises around the world.⁶¹ The central bank members publicly pay lip service to the ideal of maintaining the character of the BIS, and not turning it into a lender of last resort for the world. Privately, however, they will undoubtedly continue their maneuvers to protect the banking system wherever it seems most vulnerable. After all, it is ultimately the monies of central banks at risk, not the BIS'. Meanwhile, the central banks will continue to keep using BIS as their public mask, and pay the requisite price for the disguise.⁶² Through financial crises, and its success and failures, the BIS has cultivated a low profile as the banker from which the international banking system can scheme its way out of the restrictions placed on the insolvent banks during financial crises.

The governance of the Bank is determined by its Statutes.⁶³ According to the BIS'

⁶¹ See "Settlements Bank: Clear the Way for Consolidation," *American Banker*, June 13, 1996.

⁶² See Edward Jay Epstein, "Ruling the World of Money," *Harpers Magazine*, 1983.

⁶³ See "Statutes of the Bank for International Settlements," of January 20, 1930 text as amended on 10 March 10, 2003. For a complete text, see <http://www.bis.org/about/statu-ex.htm>.

Statutes, it is prohibited from making anything but short-term loans of mostly thirty days or less, and government-guaranteed or backed with gold deposited at the BIS.

The Bank's main duties⁶⁴ include:

- purchase, sell, open account and maintain in custody gold, on the Bank's and/or central banks' behalf;
- loan or borrow from central banks;
- enter into short-term obligation transactions (bills of exchange, promissory notes, checks, etc) on its or its central banks' behalf;
- purchase or sell negotiable securities;
- discount and re-discount bills from its or its central banks' portfolios;
- create and maintain banks accounts with central banks;
- accept deposits from central banks and of other parties;⁶⁵

⁶⁴ See Articles 21 and 22 of the BIS' Statutes of January 20, 1930.

⁶⁵ Other deposits can be pertaining to trustee agreements for international settlements, as well as other deposits open based on the BIS' scope of activity.

- act as agent or correspondent of central banks; and,

- act as trustee or agent in international settlement transactions.⁶⁶

However, the Bank, unlike a “central bank,” is prohibited from printing currency; loaning or opening accounts to governments; acquiring a significant interest in any business transaction; or engaging in real estate transactions.⁶⁷

The Bank’s purchases and sales transactions on behalf of central banks are kept highly confidential. Presently, approximately 130 central banks and international financial institutions use BIS’ operations.⁶⁸ As of March 2002, the total currency deposits kept with the BIS reached USD154 billion, which represents almost 7.6 percent of world foreign-exchange reserves. A high percentage of the reserve assets held by central banks in deposits with the BIS need to be available to them at short notice. As result, the Bank focuses upon maintaining a high degree of liquidity. Funds deposited with the Bank are placed in the market mainly in the form of investments with major international banks and through the buying of short-term government

⁶⁶ In 1986 through 1999, BIS served as an agent for the private clearing and settlement system of the European Currency Unit, at the creation of the European Monetary Union. Since the early 1980s, acting as agent for the IMF and the World Bank, the bank has arranged bridge loans for member states and emerging market countries. As result, these loans speed countries’ access to IMF or World Bank credits. Most recently notable, at the end of 1998, the BIS arranged a \$13.28 billion credit facility for Brazil as part of a financial support program.

⁶⁷ See Article 24 of the BIS’ Statutes of January 20, 1930.

⁶⁸ See “Reforming Bank Capital Regulation, U.S. Shadow Financial Regulatory Committee,” Washington AEI Press, 2000.

securities. The Bank also carries out a range of foreign exchange and gold related operations on behalf of central banks and international financial institutions.

The BIS is actively looking to develop its investment services, responding particularly to the concern of central banks to increase the return on their foreign assets. Therefore, to assist central banks with longer-term reserve management, the BIS offers investment instruments of up to 5 years.⁶⁹

The BIS also offers a variety of asset management services for central banks, including enhancement of individual customer services, knowledge exchange, dedicated portfolio mandates, an open-end fund structure, and allowing blocks of customers to invest in common pools of assets.⁷⁰

The BIS makes short-term loans to central banks in the form of secured credits against gold, other collateral or currency deposits held with the bank. The Bank also provides loans on an unsecured basis, for example in the form of a standby credit on which a central bank can draw at short notice. In recent decades, the BIS has provided financial support to central banks with the backing, by way of guarantees, of a group of leading central banks. This kind of assistance usually has pre-financed disbursements of credits granted by international institutions (the IMF or the World Bank).

⁶⁹ See Charles J. Siegman, "The Bank for International Settlements and the Federal Reserve," 1994, *Federal Reserve Bulletin* 80 (10): 900-906.

⁷⁰ See Kristin K. Howell, "The Role of the Bank for International Settlements in Central Bank Cooperation," 1993, *Journal of European Economic History* 22 (2): 367-380.

An important role of the BIS' financial activities is the Bank's risk control functions consisting of Internal Audit, Credit Risk Control, and Treasury Risk Control. Thanks to a state of the art methodology, the Bank's market and credit risk research and analyses are measured and managed under an integrated economic capital framework. In particular, research and analyses on asset quality is rigorously and constantly monitored from the Bank's risk control management.⁷¹

But how does the Bank put everything together in order to “promote the co-operation of central banks and to provide additional facilities for international financial operations and to act as a trustee or agent”⁷² for international financial settlements? It is the Bank's organizational structure and management which makes it run efficiently and with a rigorous discipline.

The three most important decision-making bodies within the Bank are:

- the General Meeting⁷³ of member central banks;

⁷¹ See “Profile of the BIS - Bank for Central Banks,” October 2002, <http://www.bis.org/about/profcbank.htm#pgtop>.

⁷² See Article 3 of the BIS' Statutes of January 20, 1930.

⁷³ See Chapter V of the BIS' Statutes of January 20, 1930.

- the Board of Directors,⁷⁴ and,

- the Management⁷⁵ of the Bank.

In the year 2003, the Bank counted 50 “shareholders” (central banks or financial monetary authorities⁷⁶) as members,⁷⁷ exercising the rights of representation and voting at General Meetings⁷⁸ in proportion to the number of BIS shares issued in their respective countries. The General Meeting is held annually, usually on the second Monday in June.⁷⁹ At the General Meeting, the shareholders approve the Annual Report, including the annual financial statement of the Bank (the Balance Sheet and the Profit and Loss Account); approve changes in the

⁷⁴ See Chapter IV of the BIS’ Statutes of January 20, 1930.

⁷⁵ See *id.*

⁷⁶ A financial monetary authority from a central bank member may be a nominee to participate in the General Meeting, having voting right, if such nomination is not exercised by the respective central bank, as well as the Board of Directors approves such appointment which is not objected by such central bank. If there is no central bank, then the Board has the power to appoint a financial authority in that member country. For more information, see Article 14 of the BIS’ Statutes of January 20, 1930.

⁷⁷ Members are the central banks or monetary authorities of Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, China, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Iceland, India, Ireland, Italy, Japan, Korea, Latvia, Lithuania, the Republic of Macedonia, Malaysia, Mexico, the Netherlands, Norway, Poland, Portugal, Romania, Russia, Saudi Arabia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Kingdom and the United States, plus the European Central Bank.

⁷⁸ See below about “General Meeting”.

⁷⁹ See Article 45 of the BIS’ Statutes of January 20, 1930.

remuneration, fees and allowances of the members of the Board of Directors; elect Auditors; and discharge the Board from any responsibilities. The General Meeting may also be called in extraordinary sessions where the shareholders have the right to amend the Statutes, change the capital of the Bank, as well as call to liquidate the Bank.⁸⁰

The Board of Directors of the Bank is composed of the governors of the central banks of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States of America. The current Statutes allow the governors (appointed members) of the central banks of Belgium, France, Germany, Italy, the U.K., and the U.S. to appoint another individual of the same country to the Board, of Directors; these are known as ex-officio members.⁸¹ The statutes also provide⁸² for the election to the Board of no more than nine governors of other member central banks than the appointed member countries. The governors of the central banks of Canada, Japan, the Netherlands, Sweden and Switzerland are currently elected members of the Board, which totals 17 members. The Board of Directors elects a Chairman from among its members and appoints the President of the Bank. Since 1948 the two offices have been vested in one person. The Board's main role is to represent the Bank in its dealings with third parties and to enter into undertakings on behalf of the Bank.⁸³

⁸⁰ See Article 47 of the BIS' Statutes of January 20, 1930.

⁸¹ See Article 27 of the BIS' Statutes of January 20, 1930. As stated in the Article 27 (1), the six directors are appointed "*to attend and exercise the powers of a Director at meetings of the Board if the Governor himself is unable to be present.*"

⁸² See Article 27 (3) of the BIS' Statutes of January 20, 1930.

⁸³ See Articles 36 and 37 of the BIS' Statutes of January 20, 1930.

The Management of the Bank consists of the President,⁸⁴ who can also be the Chairman or a member of the Board of Directors, General Manager or a Deputy General Manager,⁸⁵ Heads of a department, or other officer or staff of the Bank.⁸⁶ The staff of the Bank, including temporary staff, in the year 2003 numbered over 500 employees from over 40 countries.⁸⁷ The President of the Bank implements policies approved by the Board as well as supervises administration of the Bank's activities.⁸⁸ The General Manager, as the head of the Bank's operating staff, reports and coordinates the daily activities of the Bank, and reports this information directly to the President.⁸⁹

The BIS acts as secretariat for committees which include the Markets Committee,⁹⁰ the Committee on the Global Financial Systems,⁹¹ the Basle Committee on Banking Supervision,⁹²

⁸⁴ See id.

⁸⁵ See Article 40 of the BIS' Statutes of January 20, 1930. Such people hold the position of the chief operating staff.

⁸⁶ See Articles 40 & 41 of the BIS' Statutes of January 20, 1930.

⁸⁷ See "Profile of the BIS - Administration," February 2001, <http://www.bis.org/about/profadmin.htm#pgtop>.

⁸⁸ See Article 38 of the BIS' Statutes of January 20, 1930.

⁸⁹ See Article 40 of the BIS' Statutes of January 20, 1930.

⁹⁰ The Markets Committee was established in 1962.

⁹¹ The Committee on the Global Financial System was established in 1971.

⁹² The Basle Committee on Banking Supervision was established in 1974.

and the Committee on Payment and Settlement Systems.⁹³ These committees participate in the the Financial Stability Forum which was created in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.⁹⁴ In addition to the Financial Stability Forum, the Bank has created the so-called Financial Stability Institute which provides a venue for international discussions among high level officials in the banking and financial sectors in order to promote better and more independent banking, capital markets, and insurance supervision.⁹⁵ As to insurance supervision, the Bank organizes the secretariats of the International Association of Insurance Supervisors and the International Association of Deposit Insurers, who do not have any direct relationships with the Bank and its member central banks. Respectively, these insurance agencies focus on the business of insurance and deposit insurance for financial institutions.

With some exceptions, BIS' officials are not members of the Markets Committee, the Committee on the Global Financial Systems, the Basle Committee on Banking Supervision, and the Committee on Payment and Settlement Systems. Membership in these committees consists normally of national technical experts in the fields of banking and finance. However, the Bank helps to organize meetings of such committees and performs secretarial functions for the committees.⁹⁶

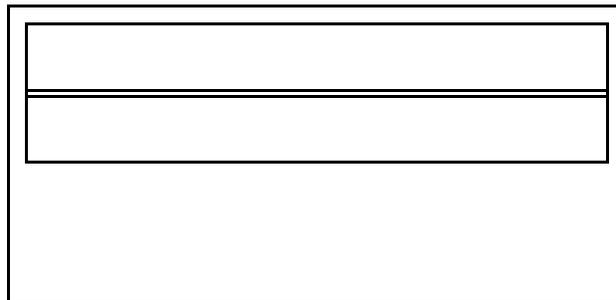
⁹³ The Committee on Payment and Settlement Systems was established in 1990.

⁹⁴ To learn more about the Financial Stability Forum, please visit the forum's official website at <http://www.fsforum.org/home/home.html>.

⁹⁵ To learn more about the Financial Stability Institute, please visit the institute's official website at <http://www.bis.org/fsi/>.

⁹⁶ See Part III of this Article where the committees are discussed..

BIS is a paramount institution in the preparation of research and analysis into monetary and financial issues. Among its services, the Bank's Monetary and Economic Department maintains a macroeconomic database



accessible by member central banks and international financial institutions.⁹⁷ This department publishes financial matters of concern to central banks in the BIS Papers (or so-called BIS Working Papers) and in academic journals and conference volumes of central banks. The research work carried out by the Monetary and Economic Department also includes wide-ranging reviews on international economic and financial developments, which are contained in the BIS Annual Report and Quarterly Review. The Department's publications remain a model for central banks and major financial institutions.⁹⁸

During its more than 70 year history, the BIS has adapted well to major changes in the financial industry and central banking practices. Ability to adapt is due mainly to its limited and largely homogeneous membership. An example is the way the Bank quickly rose to the challenge of meeting regulatory deficiencies at the international level. The Bank has also demonstrated its ability to persuade not only the most developed but also many of the less developed countries, to

⁹⁷ See Richard Tilly, "Reflections on the Early History of the Bank of International Settlements," 2000.

⁹⁸ See "Profile of the BIS - Centre for Monetary and Economic Research," October 2002, <http://www.bis.org/about/profcentre.htm#pgtop>.

implement its standards for maintaining and improving soundness and safety in their banking systems.

In order for the Bank to continue a significant player in the international banking arena, it needs to adapt its activities continuously. Changes in business practices among banks as well as changes in the technology that accomplishes those practices put pressure to change upon the Bank. Changes might be beneficial in the Bank's inner structure as well in its relationships to its customers, including the central banks, particularly in undeveloped countries. Escalating globalization of the economy is today forcing banking to become increasingly international. The system can not let central banking run nationally while commercial banking is going international. The role of the BIS in riding with this evolution is indispensable.

The Bank currently consists of a wide array of committees that report to various bodies, with different memberships and different sponsors. This structure often creates confusion about the allocation of responsibilities and the particular missions of each committee or group within the BIS. It also contributes to the lack of transparency in the Bank's role. The BIS's success as a meeting ground for central bankers has been facilitated by its small, homogeneous and cohesive membership. For that reason, membership expansion through other means, such as the Financial Stability Forum, might be a potential disruptive development for the BIS, and should be undertaken cautiously. The risk is that inclusion may be at the expense of efficiency.⁹⁹ Also, any

⁹⁹ See Michele Fratianni and John Pattison, "An Assessment of the Bank for International Settlements," October 31, 2000. The paper is available at <http://phantom-x.gsia.cmu.edu/IFIAC>.

expansion of membership in the Bank, its committees or groups should be undertaken gradually and deliberately in order to avoid disruption of the information exchange that central bankers find valuable.¹⁰⁰

While it is quite difficult to make specific recommendations on how to restructure the BIS, it is our belief that some streamlining of the BIS organizational structure might be necessary.

Through its ever increasing role, the BIS has helped create international financial order. The Bank continues to remain a relevant financial institution. It has expanded from a regionally oriented agency to a financial institution with global outreach. While the Bank has not been quite successful in acting with other international organizations to solve regional economic and currency crises, it has been a focal point for cooperative efforts among central banks that supplement the IMF and the World Bank actions.

The BIS' reputation stands as a pre-eminent economic forecaster and disseminator of financial data, in its efforts at reducing Y2K problems, for coping with technical innovations in international banking, securities and insurance activities, for encouraging transparency in financial transactions across national borders, for dealing with international money laundering, and much more. Yet, it is not clear why most of the achievements could not be brought within

¹⁰⁰ See report Meltzer report on the future role of international financial institutions, including BIS prepared by an International Financial Institution Advisory Commission, March 2000. For more information, see <http://www.boell.org/docs/meltzer.pdf>.

the functions of private, international commercial banks. Most regulations on banking, securities and insurance activities have been harmonized within the European Monetary Union and, even earlier, within the U.S. and so forth, without the need for such organizations as the BIS. However, the Bank is increasingly found to be a closed club for central bankers, without clear defined lines of accountability to national governments.¹⁰¹

How far the BIS will go is anybody's guess. No matter where it goes, the Bank's impact is felt not only by central bankers and their governments, but also by those who do not follow the Bank's developments closely. As one journalist wrote about the Bank's role, "Behind closed doors one now hears open discussions of the printing of money. That sure as hell scares me. I visualize the Bank for International Settlements in Basle, opposite the railroad station, a heavy iron grille across the door. Inside, they are drinking cups of coffee that cost \$3 in American currency. The Swiss inflation rate has been so low that the dollar has ballooned, as tourists know. It's not Swiss money they're talking about printing. A trillion dollars in dollars."¹⁰²

Since its inception, the Bank established itself as an avant garde institution in improving and strengthening relationships among central banks, financial national regulatory agencies, and international financial institutions for the coordination and improvement of their activities. Obviously, this remains a difficult and ongoing task which the Bank seems to be handling successfully, so far. At the end, as the result of domestic financial markets going global, the success

¹⁰¹ See A.M. Endres, "Review of James C. Baker *The Bank for International Settlements: Evolution and Evaluation*" Economic History Services, jul 11, 2003, URL : <http://www.eh.net/bookreviews/library/0645.shtml>.

¹⁰² See George Jerome Goodman, "Maybe I Am Easily Scared," *The Atlantic Monthly*, December 1978, Volume 242, No. 12; pp. 35-47.

of the Bank lies not only in its ability to issue financial guiding instructions, but also in the willingness of international and national financial banks and institutions to implement them.¹⁰³

CHAPTER III

Start of International Bank Supervisory Authority

A. BIS-Related Activities

BIS's work on the regulation of international banking has been accomplished through a series of committees both within and without itself. On its website, it describes itself as "a forum to facilitate cooperation between central banks on policy issues relating to monetary and financial stability."¹⁰⁴ The committees which concern us here are formally affiliated neither with BIS nor with each other.¹⁰⁵ Of the committees, three are so-called permanent committees. They are the Basle Committee on Banking Supervision, the Committee on Payment and Settlement Systems and the Committee on the Global Financial System. The committees and their work are as follows:

¹⁰³ See "The Regulator Who Is Not There: Does a Global Financial System Need a Global Regulator?," *The Economist*, May 18, 2002.

¹⁰⁴ Forum for Central Banks, BIS Website: bis.org/index.htm.

¹⁰⁵ The committees, however, meet at BIS, are identified by the international banks with BIS and are described in the BIS Internet website as if they were BIS subsidiaries or affiliates. Baker, *supra*, note xx, speaks at page 72 of "BIS, through *its* Committee on Banking Regulations and Supervisory Practices," (emphasis added), the original name of CBS. In addition, in the Eatwell and Taylor reference at note 4, *infra* at p.x, "the foundations of global financial surveillance and regulation (that) have already been laid at the Bank for International Settlements in Basle."

1. The Basle Committee on Banking Supervision (“CBS”)

The oldest and probably most active of the committees, CBS is the most likely of existing BIS bodies to metamorphose into a supreme international bank regulator, or as it is sometimes called, a World Financial Authority (“WFA”). Created in 1974 by the central bank Governors of the so-called Committee of Ten countries, it was principally a reaction to the systemic risk that resulted from the international payment failure of the Herstatt Bank.¹⁰⁶ The Herstatt failure contributed to a period of instability in international banking markets¹⁰⁷ in the early 1970s and a general recognition that bank regulators in different countries had much the same problems.¹⁰⁸ The CBS thus had as its original goal the strengthening of collaboration among national

¹⁰⁶ The Herstatt Bank, based in Cologne, Germany received a funds transfer of dollars in purchase of deutschemarks. Before the Bank could wire back the currency, it was closed by the German authorities. Thus, it received but could not disburse funds. The send failure had international repercussions and took years to work out. This type of problem is still called “Herstatt risk.” The Herstatt failure was closely followed by the closing of the British-Israel Bank of London “for insolvency problems. The closure of the Herstatt and British-Israel Bank of London starkly revealed the vulnerability of the international banking system.” Lee, *The Basle Accords as Soft Law: Strengthening International Banking Supervision*, 39 Va.J.Int.L. 2, 16 (1998).

¹⁰⁷ Adding to the Herstatt/British-Israel failures were severe problems in the United States in the Franklin National Bank and the National Bank of San Diego.

¹⁰⁸ Herstatt was the key event in the creation of CBS but other world events followed that contributed to the legitimacy and solidity of CBS. Principal among these were, first, the collapse of the fixed international exchange system established by the Bretton Woods agreement in 1945 causing much more speculative investment and a general movement of funds in the currency markets. Second were “the oil shocks of 1973-74 and 1978-79” that resulted in enormous cash holdings by the middle-eastern oil states and the need for international banks to absorb and invest these funds. See Kapstein, “Governing the Global Economy,” (Harvard 1994), 31 and 58.

authorities in their prudential supervision of international banking.¹⁰⁹ It has about thirty technical working groups and task forces which meet regularly. CBS's members now come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States.¹¹⁰

As BIS says of the CBS in its website presentation,¹¹¹ it

“does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.”

From its inception, CBS as a natural result of its membership began inexorably to assume the role of an international financial services regulator. This does not appear in its publications nor, as far as one can tell, even in its deliberations. It has regularly reported to the central bank Governors of the Group of Ten countries and sought their endorsement for its major initiatives. CBS has also attracted representatives from institutions which are not central banks and through

¹⁰⁹ Thompson, *The Basle Concordat: International Collaboration in Banking Supervision*, 1 Current Legal Issues Affecting Central Banks 331, Effros Ed.(I.M.F. 1992)

¹¹⁰ The Group of 10 is actually 11 countries to which Luxembourg and Switzerland have been added for purposes of CBS. Internet website of the BIS, www.bis.org/bcbs/aboutbcbs.htm.

¹¹¹ *Id.*

them the decisions it makes carry the commitment of many national authorities outside the central banking fraternity. CBS has worked to extend its influence by stimulating contacts and cooperation between its members and the banking supervisory authorities of other countries throughout the world. In many cases, non G-10 countries have seen fit publicly to associate themselves with CBS's initiatives. Contacts have been further strengthened by an International Conference of Banking Supervisors which takes place every two years, most recently in Basle.

CBS has operated consistently with two basic principles: first, no international banking establishment should escape regulation; and second, supervision should be adequate. To accomplish these two goals, CBS has issued a number of documents since its creation:¹¹²

a. The Basle Concordat. Almost immediately upon its creation, CBS issued a blockbuster report¹¹³ that still (as revised) is the backbone of international bank regulation. Termed the Basle Concordat, "The report sets out certain principles, which the Committee believes should govern the supervision of banks' foreign establishments by parent and host authorities."¹¹⁴ Known as "consolidated bank supervision," as clarified over the years, the principles have come to dictate that the home state, the state where the bank was chartered, would be principally responsible for

¹¹² Much of the material in the following lettered paragraphs is taken from a book by one of the authors, Felsenfeld, "International Banking Regulation," (Juris 2002 Supp.), ppII-29 *et seq.*

¹¹³ The Report was begun in 1974, the year of BIS' creation and released in 1975. It was supplemented in 1990 and 1992.

¹¹⁴ Basle Report, Internet, www.bis.org/publ/bcbasc004.htm#v3d2.

the financial well-being of the institution. The host state, the state where an international bank did business, would have principal responsibility for its powers and functions. The host state was not to accept a bank unless it was subject to acceptable home state supervision. The two states were encouraged to be in regular contact with each other.¹¹⁵

b. Basle Accord on Capital Adequacy. This document, currently receiving the most attention from the banks and regulators of the world, is the set of guidelines officially titled the International Convergence of Capital Measurement and Capital Standards and generally known as the Basle Accord on Capital Adequacy or, more simply, the Basle Accord or just the Accord.

The original Accord was released in July 1988¹¹⁶ and represented CBS's effort to secure international convergence of supervisory regulations governing the capital adequacy of international banks. Right after the Mexican financial crisis of the 1980s, the U.S. regulators' efforts to force national and state banks to hold more capital led to immediate industry resistance on competitive grounds, and strengthened efforts within the Basle Committee to come up with the issuance of the Accord of 1988.¹¹⁷ The Accord reflects the effort of CBS to ensure a maximum degree of consistency between the framework agreed upon in Basle and the separate

¹¹⁵ Application of the Concordat has been enhanced by the issue on July 6, 1992 of a CBS report titled the Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments. Regulatory in nature it requires all supervisory authorities enforcing the Concordat to follow its dictates. CBS Press Statement, July 6, 1992.

¹¹⁶ 30 I.L.M. 980 (1988).

¹¹⁷ See William R. White, International Agreements In the Area of Banking and Finance: Accomplishments and Outstanding Issues," Bank for International Settlements, Monetary and Economic Department, October 1996.

rules of the constituent countries. At the same time, the Accord pays due regard to particular features of the existing supervisory and accounting systems in individual member countries. “It (CBS) believes that this objective has been achieved.”¹¹⁸ The Accord sets a minimum capital standard as eight percent, a figure that is still generally in effect.¹¹⁹

The Accord has been modified twice and one major modification is now on the drawing board.. The modifications are:

i 1996 Amendment.¹²⁰ The Amendment principally dealt with the ways banks should adjust their capital based upon market risk - the risk arising from broad risk factors as contrasted with risk of loss from specific loans and investments. Of particular importance was the addition to the Accord of qualitative standards for banks basing their capital requirements on the results of internal models, a relatively new approach to the measurement of capital proposed to the banking community in 1995. Tentatively accepted in the Amendment was use of a bank’s own internal model as an evaluation of specific risk; CBS expressed its desire that this approach be developed and improved by the banking system.

ii. 1998 Amendment.¹²¹ In a document titled “Amendment to the Capital Accord to

¹¹⁸ *Id.* at 981.

¹¹⁹ Banking regulations in the United States, depending upon the particular definition of capital, set minimum percentages at 3%, 4% and the generally accepted 8%. See, for national banks, 12 C.F.R. §3.6 and App. A to Part 3.

¹²⁰ The Amendment is discussed in a CBS document titled “Overview of the Amendment to the Capital Accord to Incorporate Market Risks” January 1996, available on the BIS website.

¹²¹ Available on the BIS website.

Incorporate Market Risks,” CBS concluded some speculations contained in the 1996 Amendment. Its principal goal in 1998 was to confirm that a bank could use its own internal model to establish both market risk and specific risk. Clearly, although the Amendment does not say this, a bank’s internally created model is the device of the future in the establishment of bank capital. Use of the model was conditioned upon a bank’s establishing supervisory approval of the model from both home and host countries.¹²² Approval is based upon four principles:

- . the bank’s risk management system must be conceptually sound and is implemented with integrity;
- . the bank has sufficient number of trained staff;
- . the model must have a record of reasonable accuracy; and
- . the bank conducts stress tests of its model.

The Amendment elaborates at some length on these underlying principles. For example, to demonstrate reasonable accuracy, the model must be shown to reflect both the bank’s activities and the geographic areas in which the activities are conducted. Stress testing is defined to mean the identification of “events or influences that could greatly impact banks.”¹²³ It is made clear that no particular type of model is required for use in the estimation of capital.

The Amendment also authorizes banks to base specific as well as market capital upon modeled estimates if the models meet a set of qualified and quantitative estimates.¹²⁴

¹²² B.1 in the Amendment.

¹²³ B.5 in the Amendment.

¹²⁴ B.8 in the Amendment.

iii. Basle II, the 2001 proposal. In 2001, CBS issued a proposed amendment to the Accord that has been voluminously studied, revised and was reissued in May 2003. CBS anticipated that it would issue a final rule based upon the amendment by the end of 2003; the due date has been deferred. Plans are for U.S. regulators to consider and probably revise the CBS product and issue a rule designed to become effective in local banking communities in 2006 or 2007.¹²⁵ Whether any of these “final” dates will materialize is at best questionable.¹²⁶

The Amendment leaves essentially intact the capital guidelines in place under the original Accord including the eight percent capital floor. It introduces, however, an alternative method of computation that has, through five years of discussion, left much of the banking community bewildered. It is not the place of this article either to describe Basle II in any detail or to evaluate it. It is based upon further use of the banks’ internal risk ratings systems as the definer of their required capital. As the most recent of the CBS prescriptions to the banking community, it reflects CBS’s sense of itself as the international regulatory leader.

The major objection of the worlds’ banks and bank regulators to Basle II is based upon its complexity, not its substance. Comprising some 500 pages, the proposal is filled with highly technical language and arcane mathematical formulations. The United States Comptroller of the

¹²⁵ American Banker, April 10, 2003, p.1.

¹²⁶ Hearings are being held in both the House and the Senate about Basle II and key lawmakers are telling bank regulators that they are skeptical about the proposed accord. The House Financial Services Committee is to consider a bill that would create a new regulatory committee under the Treasury Department to coordinate the U.S. position on Basle II. American Banker, June 23, 2003, p.1.

Currency, regulator of national banks, has testified to Congress:¹²⁷

“This (the level of detail and specificity in the proposal) has led to a proposal of immense complexity - greater complexity, in my view, than is reasonably needed to implement sensible capital regulation. I believe we must avoid the tendency to develop encyclopedic standards for banks, which minimize the role of judgment or discretion by banks applying the new rules and of supervisors overseeing the new rules. ... If we determine through our rulemaking process that changes in the Basle proposal are necessary, we will press the Basle Committee to make changes.”

c. The Core Principles. In 1995, the CBS issued the Core Principles of Effective Banking Supervision, come to be known as the Core Principles. Basically comprising 25 key areas of banking supervision, these principles are designed to present the essential ingredients of a regulatory banking structure that will stimulate confidence in the international banking market. The principles cover the significant “preconditions for effective banking supervision, licensing of banking institutions, capital standards and other prudential guidelines for risk management and internal control, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking.”¹²⁸

¹²⁷ Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the House Committee on Financial Services, February; 27, 2003.

¹²⁸ Cumming, Christine, *Financial Services Regulation*, in *Business Economics*, Vol 33, No. 4, Oct. 1, 1998, p.6.

CBS “intended the Core Principles to be applied in all countries.”¹²⁹ It issued them in its conviction that they represent the essential ingredients to make an international bank regulatory system work. Writing about its own work in 1999, CBS said “The Core Principles for Effective Banking Supervision have become the most important global standard for prudential regulation and supervision.”¹³⁰ They represent another example of CBS assuming to itself the authority to prescribe regulations for the international banking system

In October 2001, CBS issued a paper titled Customer Due Diligence for Banks. This represents CBS’s views on the generally-acknowledged duty of banks both to know their customers and generally to know the source of the assets that their customers bring.¹³¹ CBS anticipates incorporating the principles of the paper into the Core Principles in due course.¹³²

d. The Three Papers of September 1998.¹³³ In September 1998, CBS issued three papers dealing with bank regulation:

¹²⁹ *Id.*

¹³⁰ Core Principles Methodology (October 1999) available on the BIS Internet website.

¹³¹ The International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, Title III of the massive United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) of 2001, 115 Stat. 272, October 26, 2001 is at bottom a detailed application of the know-your-customer principle applicable to terrorist activities. The Act was enacted as a result of the attack of September 11, 2001.

¹³² Banking & Financial Services, August 2003, p.14.

¹³³ Discussed in Friesen, Lustgarten and Presti, *The 1998 Basle Committee Supervisory Initiatives and their Potential Consequences on International Banking Activities*, Journal of International Banking Law, February 1999.

- i. The Bank Transparency Paper. This paper advocates the use of greater contributions from market discipline and resulting public disclosure to complement the efforts already being made by the supervisory sector in controlling banks.
 - ii. The Internal Control Paper. This paper emphasizes the use of banks' internal control procedures and measurement of the effectiveness of those procedures in affecting bank performance.
 - iii. The Operational Risk Paper. The last is based upon the CBS's survey of the operational risk management techniques in use in banks. It relates those techniques to communication breakdowns and resulting financial losses in those institutions.
- e. Banks' Interaction with Highly Leveraged Institutions. In January 1999, influenced by the near collapse of Long Term Capital Management, CBS issued a report dealing with the relationship of banks and highly leveraged institutions. The 32 page document stresses aspects of bank regulation together with greater public disclosure and an improvement of bank internal practices. It noted: "Banks generally did not appear to possess effective policies and guidelines for managing exposures to some highly-leveraged institutions in a manner consistent with their overall credit standards."¹³⁴

The report is written in the form of a set of directions to bank supervisors. It says "supervisors should ensure" and should "consider these issues carefully."¹³⁵

¹³⁴ The document may be seen on the Internet at www.bis.org/publ/bcbs/45.htm.

¹³⁵ The report was issued along with a closely related report titled "Sound Practices for Banks' Interactions with Highly Leveraged Institutions."

f. Sound Practices for the Management and Supervision of Operational Risk. Issued in February 2003 by the CBS Risk Management Group,¹³⁶ this paper expands a prior paper published in 1998 and titled “A Framework for Internal Control Systems in Banking Organisations” (sometimes hereinafter the “Paper”). The Paper describes the growth of several ingredients that make the update appropriate. Among these are greater use of highly automated technologies, large scale acquisitions and mergers that test the viability of newly integrated systems and the emergence of banks as large-volume service providers, including participation in settlement and clearing systems. Basically, the Paper provides a framework for the effective management and supervision of operational risk.¹³⁷

CBS has drawn on its work on the management of other significant banking assets “such as credit risk, interest rate risk and liquidity risk, and the Committee believes that similar rigour should be applied to the management of operational risk.”¹³⁸ In the Paper it identifies a five pronged approach to the control of operational risk: “developing an appropriate risk management environment; risk management; identification, assessment, monitoring and control/mitigation; the role of supervisors; and the role of disclosure.”¹³⁹

The Paper assumes the role of a financial regulator and assigns to banks a series of

¹³⁶ Chaired by Roger Cole of the Federal Reserve Board and consisting of 23 individuals from central banks, major international banks, regulatory groups and CBS itself.

P The definition of operational risk, coming from the CBS studies of bank capital, is “the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.”

¹³⁸ Paper, p. 3.

¹³⁹ Paper, par. No. 9.

elements that should be universally undertaken in the control of operational risk. These include: the appropriate roles of the board of directors and senior management; the use of risk identification, assessment, monitoring, control and mitigation procedures; implementation of clearly designated supervisory roles; and the role of public disclosure in the control of risk. The sweep of these proposals assumes to CBS the function of an international regulator without portfolio.

g. Risk Management Principles for Electronic Banking. This paper was published in June 2003 by the Electronic Banking Group of CBS. It has two main areas of focus. The first builds on a similar paper published in May 2001 titled Risk Management Principles for Electronic Banking. The earlier paper presented 14 risk management principles to help banking institutions expand their existing risk oversight policies and processes to cover their e-banking activities. The 2003 paper stresses banks' need to integrate cross border electronic banking risks into the banks' overall risk management framework. The second objective is to identify more clearly the home country and host country responsibilities for electronic activity and to focus attention on the need for effective home country supervision of cross-border electronic activity as well as international cooperation between banking supervisors.

2. The Joint Forum on Financial Conglomerates.

In early 1996, CBS joined forces with two other international financial committees - the International Organization of Securities Commissions ("IOSCO") and the International Association of Insurance Supervisors ("IOIS") - to create the Joint Forum on Financial

Conglomerates.¹⁴⁰ (Strictly speaking not a committee, the Joint Forum essentially serves a committee function within its area.) The Joint Forum's mandate was brought up to date in 1999, but its focus remains on international conglomerates. As the activities of conglomerates both expand and refine, the area of activity is generally referred to as neither banking, securities nor insurance but rather financial services. The major founding organizations were no longer in these fields separately, but were organized around a congeries of financial activities which drew upon the various areas of traditional banking, securities activities and insurance.

In 1996 and even before this the financial services movement represented the direction of the major international financial organizations, but it gained major impetus in 2000 from enactment on November 12, 1999 in the United States of the Gramm-Leach-Bliley Act of 1999,¹⁴¹ a statute that brought banking, securities operations and insurance closer to one another.¹⁴² At first the attention of the Joint Forum was upon the larger international conglomerates; more recently it is increasingly interested in smaller firms too.

¹⁴⁰ The Joint Forum was successor to an essentially identical prior group titled the Tripartite Group and composed of the same three types of regulatory agencies. The Tripartite Group issued a report on conglomerate regulation in 1995. The United States Comptroller of the Currency issued a statement on the report on July 24, 1995 and briefly described its approach to international conglomerate regulation. Basically, it recommended continued regulation by the three types of regulator each in its own area and a high degree of access to general information by all of them as well as coordination among them. The Tripartite Group as well as the successor Joint Forum saw itself as an advisor to regulators.

¹⁴¹ Pub.L. No, 106-102, 106th Cong. 1st Sess. (1999).

¹⁴² Banks had always been in both securities activities and insurance and, even after Gramm-Leach-Bliley there were technical divisions among the three fields, but the new statute made convergence much more available.

The Joint Forum issued its first major report, titled the Supervision of Financial Conglomerates, in February 1999.¹⁴³ The Joint Forum identified itself in the report as representing the Committee on Banking Supervision, IOSCO, IAIS, thirteen countries¹⁴⁴ and the European Union (“EU”) Commission in an observer capacity. The Joint Forum addressed international conglomerates from the vantage point of a regulator and prepared a number of papers in this capacity. Dealing as it does with different financial businesses, the Joint Forum stresses what it terms the “cross-sectoral issues” related to the business on which it concentrates. The papers were released by the three parent regulator bodies in 1998¹⁴⁵ and have stimulated a new, more broadly based kind of regulation.

3. Committee on the Global Financial System (“CGFS”)

One of the three permanent committees, CGFS¹⁴⁶ was established in 1971 as successor to the Euro-Currency Standing Committee. The committee has three major tasks, all dealing - as the committee’s name indicates - with the global financial system: systematic short-term

¹⁴³ Available as Publication No. 47 on the BIS website.

¹⁴⁴ Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States.

¹⁴⁵ The papers were titled:

- Capital Adequacy Principles
- Supplement to the Capital Adequacy Principles paper
- Fit and Proper Principles
- Framework for Supervisory Information Sharing
- Coordinator
- Supervisory Questionnaire

¹⁴⁶ Website at www.bis.org.cofs/

monitoring of global financial system conditions; longer-term analysis of the functioning of financial markets; and the articulation of policy recommendations aimed at improving market functioning and promoting stability. The CGFS website lists 21 published CGFS reports through March 2003. The perspective of CGFS is upon the functioning of the global market and its work and reports are more upon that market than, as is the work of CBS, upon the operations and solvency of its constituent institutions. From this vantage point, however, it also acts as a central bank forum and submits reports and recommendations to central banks designed to enhance their responsibilities for monetary and financial stability.

A recent report that illustrates the niche occupied by CGFS is its January 2003 paper on Credit Risk Transfers.¹⁴⁷ While such devices as financial guarantees and credit insurance are long-standing features of the international marketplace, the last few years have seen the range of credit risk reduction transactions and the circumstances within which they are used widen considerably. At the same time, new credit risk transfer instruments are relatively few compared to the underlying risk-related instruments that create the credit risk itself. The paper identifies and analyzes the implications to the financial market of the growth of financial institutions in new risk reduction instruments.

4. Committee on Payment and Settlement Systems

This committee, also a permanent committee, was formally established in 1990 to continue work on both domestic and cross-border payment, and clearing systems undertaken

¹⁴⁷ Available on the CGFS website.

since 1980 by a series of different groups and committees organized by the Group of 10 countries. These relatively short-lived groups had examined such issues as the development of electronic funds transfer systems and the question of cooperation vs. competition in payment systems. The result of an early study by a so-called Group of Computer Experts in 1985 was the first of a series that has become known as “Red Books.”

5. Committee on Interbank Netting Schemes

Through the years, BIS, CBS and the other loosely affiliated committees created still other committees that studied and reported upon bank and related financial activities. One may mention a Committee on Interbank Netting Schemes created by the G10 central banks in 1990. It issued a report, actually published and released by BIS, that contains a set of minimum standards for the operation of bilateral and multilateral netting systems and sets an agreed approach for the joint oversight of such systems. Committee reports in the years since then advise central banks on such topics as the development of electronic payment issues, retail payments - largely devoted to consumer payments - the nature of payments in various selected countries and securities settlements. In connection with their work in the securities field, the Committee has done several reports together with the OSCO and covered both domestic and international settlements. The Committee has also reported on clearing arrangements for derivative products. All together, there are over 50 reports issued by this Committee on payment and settlement topics.¹⁴⁸

¹⁴⁸ A description of the Committee and a list of its publications may be found on its website at www.bis.org/publ/cpss04.htm

The Committee reflects the position of a bank regulator in its continuing belief that confidence in the banking system cannot survive without public confidence in the currency and its ability to sustain economic development. In the many ways illustrated above, the Committee seeks as a virtual public regulator to enhance that goal.

B. OTHER

Entities outside the BIS and its immediate colleagues have moved in various ways to approach the international regulation of banking and bank-related activities. We can name a few.

1. In the imposition of conditionality standards as part of its offers of financial assistance, the International Monetary Fund has positioned itself as a quasi-regulator of international banking activities. It has been mentioned as a possible senior international bank regulator.¹⁴⁹

2. The International Organization of Securities Commissions has actually joined with BCS in the regulation of financial conglomerates.¹⁵⁰

3. The Ad Hoc Group on Securities Markets set up by the Organization for Economic Co-operation and Development in the late 1980s.¹⁵¹

Moving farther afield from banking, international groups with uncertain authority work in such international fields as climate control, energy, water, fisheries, the environment and, of

¹⁴⁹ Salda, International Monetary Fund (1992), Lecture No. 131.

¹⁵⁰ See Chapter III, subdivision 2.

¹⁵¹ Lichtenstein, *International Standards for Consolidated Supervision of Financial Conglomerates: Controlling Systemic Risk*, 19 Bkly, J.I.L. 137, 143 (1993).

course, nuclear energy.¹⁵²

CHAPTER IV.

Relationship Between BIS and National Financial Authorities

The BIS issues supervisory guidance to central banks and directly to local banks and other financial institutions on various banking matters including core banking and such related problems as banknote counterfeiting,¹⁵³ international payment systems, establishment of a

¹⁵² See text *supra* at note 320.

¹⁵³ Press release by the Chairman of the Governors of the G-10, May 10, 2000. The Governors reviewed the problems raised by the use of personal computers in counterfeiting banknotes. In response to the threat of increasing use of personal computers and digital imaging

uniform foreign exchange, derivatives systems, financial risks in commercial lending, etc. Ultimately BIS must be measured by the effect it has upon the financial institutions actually in the market place. This is an evolving relationship but BIS can be accurately seen as becoming closer to the local bank.

BIS's recommendations do not have any legal force (so-called "soft law") to be implemented by national financial authorities and banks around the world. However, local authorities and banks can not simply ignore the Bank's recommendations. In such cases, they know they risk being regarded by major international banks and their financial authorities, including the BIS itself, as "unattractive" parties with whom to do business. And they know that in this global economy, they can not afford to develop their activities in isolation. Therefore, BIS's recommendations are regularly adopted not only by the central banks which are members of the Bank, but also, interestingly, in almost all non-member central banks.¹⁵⁴

All of the BIS's activities aim at promotion of an international financial stability - which was, in its originally limited scope, the main purpose of the BIS's creation. International financial stability is even more today than it was in 1929 of vital interest to the financial authorities of the world.¹⁵⁵ As for banks, financial stability starts with stable profits and fewer

tools, G-10 authorized work by a group of central banks to develop a system to deter PC-based counterfeiting.

¹⁵⁴ See Andrew Crockett, General Manager of the BIS and Chairman of the Financial Stability Forum, "International Standard Setting in Financial Supervision," lecture at the Cass Business School, City University, London, 5 February 2003.

¹⁵⁵ Remarks in a speech, "Should Financial Stability Be an Explicit Central Bank Objective?" by Vice Chairman Roger W. Ferguson, Jr. Paper presented to an International Monetary Fund conference on Challenges to Central Banking from Globalized Financial Markets, Washington, D.C. September 17, 2002. For a complete view of the speech, please go to

risk taking activities. Financial stability for all financial authorities means a developed economy, a low unemployment percentage, appropriate interest rates in lending. BIS has undertaken these goals as its mission. And, over the years, BIS has assumed a constantly increasing influence over the day-to-day affairs of local banks and other financial institutions.

After the economic crisis of the 1970's, most industrialized countries became concerned with their banks taking increased risks. Low capital levels and off-balance sheet activities were making it highly difficult for banks to be monitored by national financial authorities. This first led in 1986 to a joint undertaking between the U.S. and the U.K., which was aimed at achieving a

<http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021016/default.htm>.

Financial stability, as an explicit central bank objective among other countries, is adapted in central banks' charters.

For example, in 1977, in the Federal Reserve Act was added that "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

Under the Bank of Canada charter, it says "regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unity and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada."

The Bank of England charter states "Objectives of the Bank of England shall be (a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its goals for economic growth and employment."

The Bank of Japan charter, notes "Currency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy."

The European Central Bank resolution states "the primary objective of the ECB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community."

common risk-weighted capital measuring system. In December 1987, the joint undertaking was followed with the creation of the Basle Capital Adequacy Accord (1988). In 1989, the European Union adopted its own capital guidelines based on the Basle structure. The Accord was thereafter adopted by many non European Union countries Adoption of the Basle Accord was perceived as enhancing a country's international reputation and enabling it to operate throughout the developed financial world (including the U.S.) which increasingly required conformity with the BIS standards as a condition to carry out activities in their respective markets."¹⁵⁶ Today, there are over 120 countries, which have adopted¹⁵⁷ the revised 1988 Basle Capital Accord.¹⁵⁸

The Accord is a statement of the CBS agreed to by all its members. It provides details of

¹⁵⁶ See Enrico Colombatto and Jonathan R. Macey, 18 *Cardozo L. Rev.* 925 (1996), *The Decline of the Nation State and Its Effect on Constitutional and International Economic Law: Contribution: A Public Choice Model of International Economic Cooperation and The Decline of The Nation State.*

See Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, 39 *St. Louis U. L. J.* 885, 888, (1995). The BIS Committee includes the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, and United States) plus Switzerland and Luxembourg. This brought in Denmark, Greece, Ireland, Portugal, and Spain.

¹⁵⁷ The accord is adopted by countries under bilateral "Memoranda of Understanding" between respective country and the BIS.

See also remarks by William J. McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York before the Foreign Policy Association Conference on Global Capital Markets and a New International Financial Architecture, New York, November 17, 1999.

¹⁵⁸ See Patricia Jackson (Bank of England) "International Financial Regulation and Stability," October 4, 2002, Bank of England Publications at <http://www.bankofengland.co.uk/speeches/speech177.pd>.

the agreed framework for measuring capital adequacy and minimum reserve standards to be carried out, which the national supervisory authorities represented on the Committee intend to implement in their respective countries.¹⁵⁹ Implementation of the BIS's rules continues to be a top priority for national financial authorities of the individual countries, which do not underestimate the wide-ranging legal, infra-structural and educational changes resulting from such implementation. National financial authorities do not hesitate to establish ambitious programs with clear time frames for the rules implementation.

International financial institutions, particularly the IMF and the World Bank, should have an important role in monitoring the implementation of the BIS's rules. Those in support of this argument say that the international financial institutions already send teams of experts to almost all countries across the world, whose implementation of the BIS rules are connected to monetary policies and lending practice reforms being orchestrated by the IMF and the World Bank. In this "cohabitation," the Bank is increasingly earning a role for being primarily responsible for creating a sound and safe environment for banking activities; this, in turn, is dependent on the national financial policies sponsored by the World Bank and the IMF.¹⁶⁰

¹⁵⁹ International Convergence of Capital Measurement and Capital Standards, July 1988, 30 I.L.M. 980 (1991).

¹⁶⁰ Speech by Mr. de Swaan, an Executive Director of the Netherlands Bank and Chairman of the Basle Committee on Banking Supervision, at the 14th Annual Meeting of the Latin American and Caribbean Banking Supervisory Organizations held in Santiago, Chile on September 1, 1997. For more information of his speech, <http://www.bis.org/review/r970912a.pdf>

The major international banks and even those of lesser scope are eagerly adapting the Basle Accord in their lending businesses. The BIS's role is particularly felt in assisting emerging financial markets. The world's less sophisticated banks are adopting the BIS capital approach as they embrace capital requirements in the lending system.¹⁶¹

National financial authorities still have the dominant role in developing and utilizing prudent regulations and requirements to control risks, including those covering capital adequacy,¹⁶² loan loss reserves,¹⁶³ asset concentrations¹⁶⁴, liquidity, risk management¹⁶⁵ and internal controls.¹⁶⁶ These requirements may be of a qualitative and/or quantitative nature, and

¹⁶¹ An Overview Paper for the Impact Study, issued by Basle Committee on Banking Supervision, October 1, 2002 (Bank for International Settlements). For more information, please see <http://www.bis.org/bcbs/qis/qis3ovrv.pdf>.

¹⁶² Bank regulators must issue minimum capital requirements for banks that reflect the risks that the banks undertake, and define the components of capital, considering its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord. (See Principle 6 of the Basle Accord.)

¹⁶³ Bank regulators must be satisfied that banks establish and implement adequate policies, practices and procedures to evaluate quality of assets and adequacy of loan loss and reserves standards. (See Principle 8 of the Basle Accord).

¹⁶⁴ Bank regulators must be satisfied that banks manage information systems which enables to identify concentrations within the portfolio and regulators must place prudential limits to restrict bank exposures to single borrowers or groups of related borrowers. (Principle 9 of the Basle Accord).

¹⁶⁵ An essential part of a banking monitoring system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios. (See Principle 7 of the Basle Accord).

¹⁶⁶ Bank supervisory authorities must determine that banks have established internal controls which is adequate for the nature and scale of business, including clear arrangements for

their purpose is to limit banks' imprudent risk-taking. These requirements guide but are not a substitute for management decisions. They rather establish minimum calculated standards that ensure that banks conduct their activities in a suitable manner. The evolving nature of banking requires national supervisory authorities to assess sound requirements constantly, evaluate the continued applicability of existing requirements and also assess the need for new requirements.¹⁶⁷

Implementation of the Basle Accord requires a substantial commitment of resources by banks and their national financial supervisory authorities, and raises practical implications.¹⁶⁸

Implementing the Basle Accords by a bank is not a simple process. It depends on various factors, including the bank's size, its structure, as well as the nature and complexity of its activities. Clear strategies by the banks' management, a strong operational risk culture and internal control culture, clearly assigned responsibilities and segregation of duties, effective internal reporting

delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal and external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations. (See Principle 14 of the Basle Accord).

Bank regulators must also determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, promoting high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements. (See Principle 15 of the Basle Accord).

¹⁶⁷ Core Principles for Effective Banking Supervision. Consultative Paper Issued by the Basle Committee on Banking Supervision. Basle, April 11, 1997. For more information on the paper, go to <http://www.bis.org/publ/bcbs30.pdf>.

¹⁶⁸ Speech by Mr. Roger W. Ferguson, Jr, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Risk Management Association's Conference on Capital Management, Washington D.C., April 9, 2003.

and contingency planning, are all crucial elements of an effective operational risk management framework for banks of any size and scope.¹⁶⁹

There are certain specific areas to which banks direct their efforts in implementation of the Accords. The areas mainly include design of an internal rating system, supervision over the rating system, data requirements and validation, and corporate governance.¹⁷⁰

Banks' internal rating system policies and degrees of risk should differentiate between each other. Credit risk rating systems are more useful to the extent they distinguish differing degrees of borrower risk. Banks thus normally expand the number of ratings categories in which they keep their risk exposures. Nevertheless, it is not enough for banks to establish more rating categories. The most difficult part for banks is to determine fairly and clearly the criteria for ratings categories, providing more meaningful assessments to both individual credit exposures and overall risk profiles. Transparency of the ratings criteria is of critical importance in order to ensure that ratings are assigned in a rigorous and reliable way.¹⁷¹ Without a system of checks and balances, or control balance, any ratings system becomes useless. For any good ratings system control structure, the necessary structural elements are independence of the ratings process¹⁷²,

¹⁶⁹ Sound Practices for the Management and Supervision of Operational Risk, Basle Committee Publications No. 96, February 2003.

¹⁷⁰ Speech by Mr. William L. Rutledge, Executive Vice President of the Federal Reserve Bank of New York, at The British Banker's Association Basle 2 / CAD 3 Half Day Conference, London, UK, March 13, 2003. For more information about his speech, visit the website at <http://www.bis.org/review/r030325f.pdf>.

¹⁷¹ See letter (ISDA's Commentary On The Minimum Requirements For The IRB Approach) from Ed Duncan, International Swaps and Derivatives Association, Inc., to Nicholas Le Pan, Basle Committee on Banking Supervision, December 20, 2002, at <http://www.bis.org/bcbs/qis/resp3isda.pdf> (Fri, 28 Mar 2003).

¹⁷² Those in charge of assigning ratings and approving loans should be independent of the marketing department and revenue producers.

internal review of such ratings¹⁷³, and overall transparency.¹⁷⁴ They all contribute in consolidation of controls over ratings mechanism, which should be complemented by the collection of accurate data on which these ratings are based upon.

Obviously, a credit system is only as satisfactory as the data upon which it is based. From a broad risk management point of view, access to a bank's data history and external data enables such a bank to evaluate the performance of its internal rating and risk valuation systems in a consistent and significant way.¹⁷⁵ As result, banks are creating data "warehouses,"¹⁷⁶ enabling them, over time, to collect, store and draw upon loss statistics in an effective fashion. Designs, controls, or data that are added to a risk rating system should be evaluated based upon a strict corporate governance structure. Here, the active role of the banks' management body is crucial to the successful implementation of the Accords. Banks will apply the Accord productively only with full knowledge of the banks' operational mechanisms, including the banks' internal ratings systems and the measure of risk derived from ratings.¹⁷⁷

¹⁷³ This includes having a subsequent review of ratings by an independent review group, which reviews ratings for accuracy, timeliness and consistency. Both the ratings system and individual ratings should be subject to review by the internal audit department.

¹⁷⁴ Ratings criteria is intended to be objective. Bank has in place policies and procedures, which clearly document the rationale for each ratings category. The more transparent the process is, the easier is to audit ratings.

¹⁷⁵ Remarks by William J. Donough, President and Chief Executive Officer of the Federal Reserve Bank of New York, at The Bond Market Association: 2003 Legal and Compliance Conference, New York, February 4, 2003. For more information of his remarks, visit <http://www.bis.org/review/r030207a.pdf> (Sat, 08 Feb 2003).

¹⁷⁶ See supra [speech by Mr. Rutledge, March 13, 2003].

¹⁷⁷ Remarks by Mr. William J. McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Global Association of Risk Professionals, New

It is revealing that, according to a 2001 survey from CBS, on the annual reports of 54 internationally active banks, which included questions related to quantitative and qualitative disclosures in various pertinent categories (i.e., capital structure, capital adequacy, market risk internal modeling, internal and external ratings, credit risk modeling, securitization activities, asset quality, credit derivatives and other credit enhancements, other derivatives, geographic and business lines diversification, accounting and presentation policies, and other risks),¹⁷⁸ a majority of these banks were expanding their disclosure of lending information.¹⁷⁹ The main disclosures from the banks consisted of accounting policies, risks and capital structure. Credit risk modeling, credit derivatives, and other credit enhancements were the least widespread of the disclosures.

From 1999 to 2001, banks sought to increase the disclosure of information on securitization activities, internal and external ratings and credit derivatives and credit enhancements, operational and legal risks, liquidity risk, and interest rate risk in the banking books.¹⁸⁰ The most common individual disclosure items concerned the structure of capital,

York, February 11, 2003. For more information of his remarks, visit at <http://www.bis.org/review/r030217a.pdf> (Tue, 18 Feb 2003).

¹⁷⁸ This publication of the results of the 2001 disclosure survey is part of the sustained effort by the Basle Committee on Banking Supervision (the Committee) to promote transparency and effective market discipline in the banking and capital markets.

¹⁷⁹ Overall, in 2001, banks disclosed 63% of the items included in the survey, up from 59% in 2000 and 57% in 1999.

¹⁸⁰ Public Disclosures by Banks: results of the 2001 Disclosure Survey. Basle Committee Publications No. 97, May 2003.

accounting and presentation policies, market risk internal modeling, and the risk-based capital ratio calculated in accordance with the Basle Capital Accord parameters. In examining the banks' reporting, CBS encouraged them to expand the transparency of their use of lending credit risk mitigation methods, asset securitization, and internal ratings, given that disclosure in these areas will support use of these methods under the Accord.

CBS also encourages those banks that do not disclose their information to act according to the existing CBS disclosure guidelines issued in order to improve their disclosure procedures.¹⁸¹ And when the Basle Committee raises the red flag, banks do take notice of it.

CBS is paying particular attention to the rapid, and often difficult to supervise, expansion of e-banking activities worldwide. The Committee expects the risks of e-banking to be acknowledged and managed by banking institutions in a prudent manner accounting for the fundamental characteristics and challenges that e-banking services offer, including the unprecedented speed of change related to technological and customer service innovation, the universal nature of open electronic networks, and the integration of e-banking applications in computer systems. These characteristics are increasing and changing some traditional risks associated with banking activities, including strategic, operational, legal and reputational risks,

¹⁸¹ See Michele Fratianni and John Pattison, International Financial Architecture and International Financial Standards, *The American Academy of Political and Social Science The Annals of The American Academy of Political and Social Science* January, 2002 579 Annals 183.

consequently influencing the overall risk profile of banking.¹⁸²

While existing risk management principles remain applicable to e-banking activities, such principles must be tailored, adapted and expanded to address new challenges created by e-banking. It is incumbent upon bank management and Boards of Directors to ensure that their institutions have reviewed and modified existing risk management policies and processes to cover e-banking activities. Integration of e-banking applications demands an integrated risk management approach for all banking activities.¹⁸³

Banks in developed economies have significantly increased their risk based capital ratios, particularly with the introduction of the Basle Accord in 1988. A survey from the BIS found that the industry average capital ratio rose from 9.3% in 1988 to 11.2% in 1996. Those banks which were close to (or under) the Basle minimum capital adequacy ratio of 8% in 1988, showed a much higher overall increase than those which had historically high capital ratios.¹⁸⁴ Although the data is not completely comparable across countries, it is clear that the introduction of the Basle capital adequacy ratios was followed by a significant increase in the average capital ratios

¹⁸² Management and Supervision of Cross-Border Electronic Banking Activities, Basle Committee Publications No. 93, October 2002.

¹⁸³ Risk Management Principles for Electronic Banking, Basle Committee Publications No. 82, May 2001.

¹⁸⁴ See Patricia Jackson, "Capital Requirements and Bank Behaviour: The Impact of the Basle Accord," Basle Committee on Banking Supervision Working Papers, Number 1, April 1999.

in most industrialized countries. Bank regulators regularly set ratios higher than the Basle minimum, bank by bank.¹⁸⁵ From 1988 through 1996, 73% of banks in the most industrialized countries increased both capital and risk-weighted assets while 3 percent of banks decreased capital (and also increased risk-weighted assets). The BIS study concluded that in total 92% of banks increased their capital levels while 76% raised their risk-weighted assets.¹⁸⁶

These statistics show clear differences between the capital and lending decisions of banks and the effects of those decisions in different countries.¹⁸⁷ Studies indicate that banks with relatively low capital ratios have tended subsequently to improve these ratios - in the process outperforming the better capitalized banks.¹⁸⁸ On the other hand, in the U.S. the combination of increased capital levels and reduced risk-weighted assets by banks., may have contributed to the sharp decrease in economic growth experienced from 1988 to 1991. Some critics say that the introduction of minimum regulatory capital requirements is harming the competitiveness of the banking industry. They argue that if capital standards dictate that a bank maintain an equity position in excess of what the bank would hold independently or in response to market pressure,

¹⁸⁵ George Sheldon, "Capital Adequacy Rules and the Risk-Seeking Behaviour of Banks: A Firm-Level Analysis," *Swiss Journal of Economics and Statistics*, 132, 1996.

¹⁸⁶ S. Picer and M. D. Dierdorff, "Understanding Structured Liquidity Facilities in Asset-Backed Commercial Paper Programs," *Asset-Backed Commercial Paper Market Review*, First Quarter, Moody's Investors Service, 1997.

¹⁸⁷ John Boyd and Mark Gertler, "U.S. Commercial Banking: Trends, Cycles and Policy," in *NBER Macroeconomics Annual*, 1993.

¹⁸⁸ Wignall A. Blundell, Frank Browne and P. Manasse, "Monetary Policy in the Wake of Financial Liberalization," *OECD Working Paper*, No. 77, April 1990.

then these standards constitute an artificial constraint on the bank's operations.

Evidence supports the view that the Basle Accord of 1988, which was implemented in the U.S. in the beginning of 1990, played a role in the U.S. "credit crunch" when the portfolios of U.S. banks shifted from commercial lending into government securities. For example, shortly after the passing of the Accord, the share of total bank credit invested in commercial and industrial loans in the U.S. fell from 22.5% in 1989 to below 16% in 1994. On the other hand, the share of total bank credit invested in US government securities rose from 15% to 25% over the same period of time.¹⁸⁹ The development of risk management policies by BIS and the consideration of those policies by local bank regulatory authorities is having a salutary effect in several ways: bank regulators are evaluating the relationship of capital and bank activity;¹⁹⁰ in addition, bank regulators and bank management are both more deeply evaluating the effects of bank activity on economic activity generally.¹⁹¹

The work on bank capital and risk measurement being conducted in Basle does not ignore that many, perhaps most, banks are safe, sound and well managed. The Basle Committee found

¹⁸⁹ See Craig Furfine, "Evidence on the Response of US Banks to Changes in Capital Requirements," BIS Working Papers No. 88, June 2000.

¹⁹⁰ R. E. Shrieves and D. Dahl, "The Relationship Between Risk and Capital in Commercial Banks," *Journal of Banking and Finance*, 16, 1992.

¹⁹¹ Speech by William J. McDonough, President of the Federal Reserve Bank of New York, before the Monetary Authority of Singapore, Singapore, March 24, 2000. For more information of his speech, visit website at <http://www.bis.org/review/r000328a.pdf>

similarities and differences in the structure, methodology and application of internal rating systems among banks.¹⁹² According to a BCS study,¹⁹³ almost 30 banks and financial institutions in the most developed countries had well-developed internal rating systems.

Although there is no unique standard for the design and operation of an internal rating system, the Basle Committee concluded that banks are establishing similar strategies, including, among others: using the same types of risk factors when assigning an internal rating, accompanied by different supervision approaches in doing so; assignment of these ratings based on an assessment of the borrower; use of information gleaned from ratings for management reporting, pricing, limit setting; ways of collection and analysing of internal data to quantify risks.¹⁹⁴¹⁹⁵

¹⁹² See Range of Practice in Banks - Internal Rating Systems, "A New Capital Adequacy Framework, Supplementary Documents," BIS Press Release, January 18, 2000.

¹⁹³ In spring 1999, the BIS Committee's Models Task Force received a mandate from the Committee to embark on a study of banks' internal rating systems and processes, and to evaluate the options for relating internal ratings to a regulatory scheme.

¹⁹⁴ See Pierre-Yves Thoraval, Bank Supervision Director at the French Commission Bancaire, and Chairman of the Working Group responsible for this report.

¹⁹⁵ There is much for local bank regulators to do in applying the Basle Capital Accord standards. In determining whether a bank may rely on its market risk model for capital purposes, national financial supervisory authorities need to evaluate the technical fundamentals of the model, as well as to establish risk control and management procedures for implementation of such model. Particular attention should be paid to whether the model is based on reasonable risk assumptions, whether a bank is appropriately using back-testing procedures, performance of the model under normal and stressed market conditions, and the overall use of models, including the model evaluation process and the new product approval process. Remarks by Mr. William J. McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Twelfth International Conference of Banking Supervisors, Cape Town, South Africa ,

Since the birth of the 1988 Accord, the Basle Committee on Banking Supervision has produced numerous policy statements dealing with sound risk management practices for bank related first to derivative activities and most recently involving the management of interest rate risk.¹⁹⁶ One of the latest notable accomplishments of the Basle Committee was the creation of new capital standards for market risk in trading activities, reflecting a new approach for building international banking standards. Banks and other financial institutions apply the new capital standards to their existing risk management practices, resulting in increased efficiency.¹⁹⁷

Promoting sound risk management in banks is a goal which bank regulators need to pursue aggressively when they consider to implement new banking policies and regulations. This should be compatible with underlying economics and market demands in respective countries to the extent of building on “best” or sound banking practices in designing rules and

September 18, 2002. Other important tasks for the bank regulators are to audit how banks are managing operational risk management and control structures from a corporate governance point of view, to analyze banks’ assessments of their economic capital requirements for operational risk, and to examine how this capital is allocated to business lines to strengthen efforts for improving internal controls. The regulators’ ultimate goal is to ensure that the internal processes in place are in fact working and are effective in mitigating the relevant risks of banks’ activities. See, *supra*, [speech by Mr. Rutledge, March 13, 2003].

¹⁹⁶ See speech by Masaru Hayami, “Financial system stability and future agenda - need to strengthen the capital base,” Governor of the Bank of Japan, at the Fiftieth Anniversary Symposium of the Institute for Financial Affairs, Tokyo, on 14 July 2000.

¹⁹⁷ See speech by Robert T Parry, “Monetary policy in a new environment - the US experience,” President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, at the Joint Bundesbank/BIS conference on "Recent developments in financial systems and the challenges for economic policy", held in Frankfurt, 28-29 September 2000.

regulations, leading toward a common end. Identifying those practices and deciding how to apply them as supervisory or regulatory standards will also strengthen relations among national financial authorities, proving invaluable in times of market stress.

Among banks and related financial institutions, there are significant differences in operations, structure, and historical development. No single or specific technique is the best for every institution in its risk measurement, modeling processes or, of course, regulatory capital standards. The current proposals to the Capital Accord encourages banks to adapt their own risk measurement and management processes to their own needs, determining for themselves the proper incentives and techniques for managing their affairs. However, it is at the same time necessary for bank regulators to limit the level of flexibility embodied in the Accord's recommendations.¹⁹⁸ Bank regulators must develop flexible, market-compatible regulations and also cautiously rely on market discipline and on banks' internal incentives. The modern approach also demands that the public be provided information on the risk exposures of banks and their procedures to manage these risks.¹⁹⁹ Public disclosure of information about financial institutions varies widely throughout the world; not infrequently, such disclosure practices are minimal at

¹⁹⁸ See remarks of Laurence H Meyer, "Capital standards and community banks," member of the Board of Governors of the US Federal Reserve System, at the Ohio Bankers' Day Conference, Columbus, Ohio on 15 March 2001.

¹⁹⁹ See remarks of Laurence Meyer, "The new Basle capital proposal," Member of the Board of Governors of the US Federal Reserve System, at the Annual Washington Conference of the Institute of International Bankers, Washington, D.C., 5 March 2001. The extent that public perception is a vital cog in controlling banks is a major issue in the Congressional and regulatory review of the deposit insurance system. Many believe that deposit insurance should be reduced in order to increase the public's supervisory function.

best. In adding transparency to the providing of market information, bank regulators may attract an increased number of investors interested in banks and other financial institutions, leading to the growth of local capital markets.

On the other hand, the role of banks in increasing disclosure may lead to expansion into other financial and non-financial sectors. Of course, the more information shared and disclosed by banks about their condition and future prospects, the less degree of uncertainty will be felt by investors.²⁰⁰

Bank regulators should exercise caution when implementing the Basle Committee on Banking Supervision's recommendations. Often regulators create new or different techniques, based on the Basle Committee's recommendations, which might impair their oversight efforts or which do not relax them beyond prudent limits. In globalized markets, weak or ineffective supervision in countries of any economic size might have far reaching consequences. These are precisely the concerns of the Basle Committee, which systematically tries to identify the respective roles and responsibilities of home and host bank regulatory authorities. It remains the imperative duty of bank regulators to coordinate with sister regulatory authorities in other countries in order to administer agreed-upon standards of financial institution

²⁰⁰ See Remarks of Roger W Ferguson, Jr., "Community and regional banks - increasing complexity and risk-management needs," Vice-Chairman of the Board of Governors of the US Federal Reserve System, at the 106th Annual Convention of the North Carolina Bankers Association, White Sulphur Springs, West Virginia, May 21, 2002.

safety and soundness.²⁰¹

Implementation of the Basle Committee on Banking Supervision's recommendations often has become too costly and burdensome for banks. Sometime, these recommendations put a crimp in a particular banking activity. However, such barriers are overcome by banks, whose fundamental objective is to create a risk-based capital system and to promote better risk management, which leads towards a safer banking system. Banks, principally large banks with exposure to international activities are extensively participating in discussions for the production of a better risk prevention system addressed to both the needs of private and public financial institutions. The Basle Committee and national bank authorities take banks' comments and suggestions seriously, and respond to them accordingly.²⁰² The relationship between bank regulators and banks is ongoing and operates best when it includes the industry's understanding that the regulator's wider objective is to develop a safer and sounder banking system by strengthening risk management in banking institutions.²⁰³

The U.S. adopts the Basle proposals under the statutory authority of the

²⁰¹ See Testimony of Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises of the Committee on Banking and Financial Services of the US House of Representatives, March 19, 1997.

²⁰² Remarks by Edward W. Kelley, Jr., a member of the Board of Governors of the US Federal Reserve System, at the Seminar on Banking Soundness and Monetary Policy in a World of Global Capital Markets sponsored by the International Monetary Fund and held in Washington, January 29, 1997.

²⁰³ Remarks by the Vice Chairman of the Board of Governors of the US Federal Reserve System, Alice M. Rivlin, at the The Brookings Institution National Issues Forum in Washington, December 19, 1996.

International Lending Supervision Act.²⁰⁴ On an interagency basis, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation are all represented on the CBS. The Federal Reserve is also represented in the Committee on Payment and Settlement Systems. The Federal Reserve and the other bank regulatory agencies have increasingly recognized the significant role of the Basle Accord on Capital Adequacy, particularly its introduction of risk-based capital requirement recommendations.²⁰⁵ U.S. bank regulators work systematically with banks in order to supervise their implementation of the Basle's minimum capital requirements.²⁰⁶ Shortly, after the introduction of the 1988 Accord, a new trend occurred in U.S. commercial bank portfolios consistent with the new economic incentives given to bank managers. Banks²⁰⁷ started to reduce their investments in commercial lending and began instead to invest in government securities. By way of example, the total share of bank credit invested in commercial loans dropped from 22.5% to 16% during the period 1989 to 1994, while credit invested in U.S. government securities increased from 15% to 25%.²⁰⁸

²⁰⁴ See 12 USC 3901 et seq.

²⁰⁵ Under the 1998 Agreement, banks should hold a higher percentage of equity capital for loan than for government security. Considering that loans are presumably more risky than securities, these new capital regulations seem to improve the link between bank risk and bank capital. Considering also the common view that equity capital is more costly than alternative funding sources, these requirements made lending more expansive than purchasing securities, which in turn provided an incentive for banks to shift their portfolios away from loans and into securities.

²⁰⁶ See 12 U.S.C. § 3907, Capital Adequacy: “(a)(1) Each appropriate Federal banking agency shall cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions ...”

²⁰⁷ Banks which are bound by the capital requirements are commercial and savings banks, credit unions, foreign bank branches and agencies, Edge Act corporations.

²⁰⁸ See supra [Craig Furfine, “Evidence On The Response Of U.S. Banks To Changes In Capital Requirements,” BIS Working Papers No. 88 - June 2000, see <http://www.bis.org/publ/work88.pdf> (Tue, 20 Jun 2000).]

In the U.S., some long time critics believe that BIS' proposed rules are too complex and unnecessary to be implemented by U.S. banks and their regulators. ²⁰⁹ One of those critics was John D. Hawke, Jr., head of the Office of the Comptroller of the Currency, who said, in addition, that, "U.S. banks - led by credit card lenders - were united in opposition to a provision requiring them to hold capital for expected losses on problem loans," arguing that banks today set aside reserves or charge high prices for products like credits cards in order to cover their expected losses.²¹⁰ CBS acceded to Comptroller Hawke's objection and reduced its capital design to where capital would have to be held only against unexpected, and not expected, losses.²¹¹ Concern was also expressed concerning a decision by U.S. bank regulators that the Basle rules would apply only to some ten leading banks that account for about 99% of the foreign exposure in the U.S. banking system.²¹²

In general, the U.S. regulatory agencies see BIS as an entity that helps in developing compatible regulations to maintain a healthy international banking system which meets the growing needs of the U.S. economy. The effect of BIS's work is to enable U.S. institutions to compete safely on a nondiscriminatory basis.²¹³ If there were regulatory

²⁰⁹ BCS has dropped its wish that US regulators adapt the Basle Accord II rules by the end of 2003.

²¹⁰ See Gary Silverman, "US Regulator Voices Basle Concerns," Financial Times, September 13 - 14, 2003.

²¹¹ American Banker, October 21, 2003, p.1.

²¹² Id.

²¹³ See remarks of William J McDonough, "Bank supervision and credit standards under Basle II - perspectives for SMEs," President and Chief Executive Officer of the Federal Reserve Bank of New York and Chairman of the Basle Committee on Banking Supervision, at the G urzenich K oln, Cologne, Germany, 25 April 2002.

competition between BIS and the U.S. bank regulators, the U.S. Congress at some point might oppose the work in Basle. It is also, however, conceivable that such regulatory competition could demonstrate advantages from accommodating different risk reduction recommendations and permitting financial institutions to have alternative ways to protect their business.²¹⁴

Surveys over the years have tended to show that, despite a natural inclination in banks to keep their internal information confidential, demands by law and by regulatory authorities to disclose their affairs to the public have had relatively good effects. Pressures from Basle and from local regulators continue in this direction, including such proposals as that the banks' so-called "call reports" be made available to the public²¹⁵.

The Federal Reserve and other U.S. bank supervisory agencies believe that the Basle Committee on Banking Supervision's approach on internal credit risk ratings of banks will be a major step for bank supervision and regulation and will also have major implications for banks, not only in the U.S., but also around the world. It seems to be a step in the right direction, keeping pace with market practices and addressing developments that undermine current

²¹⁴ Speech by Susan S Bies, Member of the Board of Governors of the US Federal Reserve System, at the Annual International Symposium on Derivatives and Risk Management, Fordham University School of Law, New York, 8 October 2002.

²¹⁵ See speech by William J McDonough, "The foundation of financial stability," President and Chief Executive Officer of the Federal Reserve Bank of New York, before the 50th Anniversary Symposium of the Bank of Korea, held in Seoul, on 8 July 2000.

standards.²¹⁶ In sum, the Federal Reserve and other U.S. bank supervisory agencies are committed to the efforts of CBS and the direction they are taking..²¹⁷ Standards set by CBS are finding their way into the bank examination process.²¹⁸ Large U.S. banks have already commenced implementation of the Basle II Accord rules. The Federal Reserve is working in combination with banks to provide improved training techniques. Encouraged by BCS, local banks and regulators are increasingly setting their sights on global as well as domestic issues. Worldwide consolidated supervision is becoming an accepted part of banking.²¹⁹

The Federal Reserve is actively involved in the 10 meetings each year among G-10 central bank governors, under the auspices of the BIS, where they exchange information on global economic issues, including the risk profiles of internationally active financial

²¹⁶ Remarks on a speech, “Financial Market Lessons for Bankers and Bank Supervisors,” by Vice Chairman Roger W. Ferguson, Jr. Before the Bond Market Association, New York, New York October 28, 1999. For a complete speech please visit [http://www.federalreserve.gov/BOARD DOCS/SPEECHES/1999/19991028.htm](http://www.federalreserve.gov/BOARD_DOCS/SPEECHES/1999/19991028.htm)

²¹⁷ See testimony of Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, June 20, 2001.

²¹⁸ Remarks by Governor Susan M. Phillips in a speech, “International Competition: Should We Harmonize Our National Regulatory Systems?,” at the Seminar on Banking Soundness and Monetary Policy in a World of Global Capital Markets, Sponsored by the International Monetary Fund, Washington, D.C., January 28, 1997. For a complete speech, please visit at <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/1997/19970128.htm> See also remarks by Governor Laurence H. Meyer in his speech, “Basle II: Moving from Concept toward Implementation”, at the Bank Administration Institute's Conference on Treasury, Investment, ALM, and Risk Management, New York, New York, October 15, 2001. For a complete speech, please visit <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2001/20011015/default.htm>

²¹⁹ Remarks by Governor Susan M. Phillips in his speech, “The Changing Financial Landscape and Umbrella Supervision,” at The Exchequer Club, Washington, D.C., June 18, 1997. For a complete speech, please visit <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/1997/19970618.htm>.

conglomerates and holding companies.²²⁰ Alan Greenspan Chairman of the Federal Reserve Board, in his testimony to the Congressional Sub-Committee on Financial Institutions and Consumer Credit, said “Risks managed on a consolidated basis can not be reviewed on an individual legal entity basis by different supervisors.”²²¹ BIS and its constituent committees are increasingly emphasizing, that for a bank operating in a large financial group, it is necessary to look not only at the soundness of the bank itself but also at the group as a whole.

In the EU, Basle recommendations serve as the basis to issue EU banking directives, which are legally binding in all European member countries.²²² Among the most relevant EU directives with respect to the EU’s compliance with the BIS’ recommendation are: the EU Directive on Investment Services;²²³ the EU Directive on Capital Adequacy;²²⁴ the EU Directive on Solvency Ratio;²²⁵ the EU Directive on Own Funds;²²⁶ and the EU Directive on

²²⁰ Remarks by Governor Laurence H. Meyer in his speech, “Globalization and U.S. Monetary Policy,” Before the Institute for Global Management and Research, School of Business and Public Management, The George Washington University, Washington, D.C., October 14, 1997. For a complete speech, please visit <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/1997/199710143.htm>

²²¹ See speech by the Deputy Governor of the Bank of England, Howard Davis, held on February 22, 1997 at the Federal Reserve Bank of Atlanta’s Financial Markets Conference entitled “Market and Regulatory Structures in a Global Environment.”

²²² Jackson P D, Furfine C, Groeneveld H, Hancock D, Jones D, Perraudin W, Radecki L and Yoneyama M, “Capital Requirements and Bank Behavior: The Impact of the Basle Accord,” Basle Committee on Banking Supervision Working Papers, No. 1, April 1999.

²²³ See 93/22/EEC.

²²⁴ See 93/6/EEC.

²²⁵ See 89/647/EEC.

²²⁶ See 89/299/EC.

Deposit Guarantee Scheme.²²⁷

The EU Directive on Investment Services provides the European “passport” to investment firms to offer investment services cross-border or by branches in other European member countries without the need to undergo additional authorization requirements in these countries.

The EU Directive on Capital Adequacy lays down the initial capital requirements for investment firms. The directive also establishes the amount of capital which must be set aside by both banks and investments firms to cover their market risk exposure.²²⁸ Unlike the Basle rules, the EU Capital Adequacy Directive is intended to apply not only to the institutions with international operations but also those that are purely domestic.

Currently, Basle rules and the EU Directive on Capital Adequacy are under revision.

There is a good likelihood that the final drafts of the Basle and EU capital rules will be substantially and significantly more consistent than are the current rules.²²⁹

The EU Directive on Solvency Ratio was the vehicle by which the EU implemented the

²²⁷ See 94/19/EC.

²²⁸ See Patricia Jackson (Bank of England) “International Financial Regulation and Stability,” October 4, 2002, Bank of England Publications at <http://www.bankofengland.co.uk/speeches/speech177.pd>.

²²⁹ See speech by David Clementi, Deputy Governor of the Bank of England, at a Financial Services Authority Conference, held in London, December 2, 1999.

1988 Basle Capital Accord into a EU law.

The EU Directive on Own Funds determines the composition and the basic standards for the funds of credit institutions and specifies the qualifying criteria for certain own funds items although EU member countries are free to apply more stringent provisions if they wish.

Under the EU Directive on Deposit Guarantee Scheme, the home country deposit protection scheme of a bank also covers deposits of the bank's branches in other EU jurisdictions.

Under the First Banking Directive of 1978, banks within the EU had the authority to implement the recommendations proposed by the BIS, and other international banking institutions.²³⁰ By way of example, institutions subject to reserve requirements in various European member countries are:

- Austria, all domestic credit institutions;
- France, all credit institutions except the Caisse Francaise de Developpement;
- Germany, with few exceptions, all institutions doing the business of banking;

²³⁰ See EC Banking Directive 77/78/EEC.

- Italy, all credit institutions except very small ones; and,
- the U.K., all authorized banks except very small ones.²³¹

Many European member states implemented general banking risk reserves before the BIS commenced work to introduce the concept of loan-loss reserves in capital, including disclosure requirements.²³²

Within the EU, the supervisory authority on banking and securities is shared among the national financial supervisory authorities, European Central Bank²³³ and other international institutions, such as the BIS. This overlapping power, among supervisory institutions, potentially represents a conflict of interest.²³⁴

The Bank of England and its successor Financial Services Authority have a close relationship with the BIS' various committees and institutions. The Bank and the Authority

²³¹ BIS ECONOMIC PAPERS No. 47 n July 1997 THE IMPLEMENTATION OF MONETARY POLICY IN INDUSTRIAL COUNTRIES: A SURVEY by Claudio E.V. Borio. For more information, see <http://www.bis.org/publ/econ47.pdf> (Wed, 13 Aug 1997).

²³² See Basle Committee on Banking Supervision, Amendment of The Basle Capital Accord in Respect of The Inclusion of General Provisions/General Loan-Loss Reserves In Capital, December 1991, see <http://www.bis.org/publ/bcbs09.pdf> (Thu, 05 Sep 1996).

²³³ The Banking Supervision Committee (the "BSC") resides at the ECB. This body consists of senior representatives of the central banks and regulatory authorities of all EU countries and is thus well suited to covering the various aspects of supervision. In the event of an impending systemic crisis with potential contagion effects, the BSC could also play an important role in crisis management bringing the countries involved together.

²³⁴ See lecture by Mr. Edgar Meister, Member of the Directorate of the Deutsche Bundesbank, held at the Multinational Banking Seminar in New York , June 9, 2001.

always believed that effective supervision of financial groups must involve consolidated supervision. The cases of English bank failures e.g., Barings and Daiwa, have highlighted the difficulty that the U.K. financial authorities face in supervising banks operations which are far from their head offices. Along with strengthening their international regulatory cooperation, the U.K. financial institutions have been devoting considerable thought to the development of an internal credit ratings based on an approach to setting capital, utilizing the experience the BIS has built up in the course of its work on credit risk modeling.²³⁵

In reference to the Basle capital minimum, many of the largest international bank operations in the U.K. are in branches rather than in independent subsidiaries. This probably relates to the fact that the UK financial authorities have generally required more capital for operations of an independent bank than the Basle minimum capital requirement.²³⁶ A branch of a bank in the U.K. can operate on the Basle minimum.

The largest positive impacts of the BIS's rules implementation are undoubtedly felt in the Japanese financial sector, which has been made more open and competitive.²³⁷ The BIS has responded positively to the Japanese Central Bank's implementation of its recommendations, Japan still has a number of issues to tackle in order to strengthen its financial

²³⁵ See speech by David Clementi, Deputy Governor of the Bank of England, at a Financial Services Authority Conference, held in London, December 2, 1999.

²³⁶ See supra 19 (Patricia Jackson (Bank of England) "International Financial Regulation and Stability," October 4, 2002, Bank of England Publications at <http://www.bankofengland.co.uk/speeches/speech177.pd.>)

²³⁷ See William R. White, International Agreements In the Area of Banking and Finance: Accomplishments and Outstanding Issues," Bank for International Settlements, Monetary and Economic Department, October 1996.

stability.²³⁸ Most important is the need to strengthen Japanese banks' capital base as it applies to credit, market, and operational activities.²³⁹ Risk-based capital of Japanese banks, which are internationally active, was 11.8% at the end of March 2000, out of which Tier 1 capital was 6.6%

²⁴⁰

In accordance with BIS's recommendations, Japanese banks are working toward the redemption of high-cost capital and an increase in internal reserves through higher profits in order to achieve reduction of capital cost and an increase of return on equity.²⁴¹ Japanese banks²⁴² are increasingly facing more complex and sophisticated types of risks. In order to satisfactorily manage such risks, as well as to face severe competition ahead, the Central Bank of Japan has realized that risks and related capital charges must be measured with greater sophistication. A related problem for Japanese regulators is to deal with intensified competition triggered by the entry of foreign capital and non-financial firms into the banking industry.

²³⁸ See supra id.[the above]

²³⁹ See supra id.

²⁴⁰ According to the U.S. standard, if we calculate the Tier 1 capital of internationally active Japanese banks, it would decline from 6.6 percent to the 4 percent level.

²⁴¹ See 1988 Basle Capital Accord, and 2003 new Capital Accord. The new Capital Accord incorporates market and operational risks which are not taken into account in the current Capital Accord, in banking accounts. It also measures credit risk more precisely and impose capital charges more appropriately.

²⁴² In Japan, banks bound by the Accord's capital requirements are city banks, regional banks, regional banks II, trust banks, long-term credit banks, branches of foreign banks, shinkin banks and Norinchukin Bank.

Even the China Banking Regulatory Commission (China's national financial regulatory authority) is planning to draft regulatory rules and operational guidelines in line with the requirements of the Basle Accord. A high ranking official of the Commission daringly said, "we [Chinese bank regulators] have long been studying ways to improve the existing capital supervision system."²⁴³ Since Chinese financial markets still remain essentially closed to foreign capital investors, the extent of the implementation of BIS' recommendations to Chinese bank regulators is unclear.

South Korean bank regulators have already put into place the risk-adjusted capital standards recommended BIS. These requirements came into force at the end of 1995, and now all South Korean banks are required to maintain an equity capital position equivalent to at least eight percent. Since the late 1990s involvement of international lending agencies in the restructuring of the South Korean financial sector, the influence of the BIS's recommendations has become increasingly noticeable. BIS recommendations are used as an important policy tool in restructuring the troubled South Korean financial industry. The South Korean financial authorities apply disciplinary measures to commercial banks, including the revocation of merchant banking licenses, freezing management payrolls, prevention of dividends and even liquidation contingent upon rehabilitation plans meeting the BIS's standards. South Korean commercial banks have become so sensitive to the BIS's standards that they initiated a recall of

²⁴³ See "Banks Embrace New Basle Accord," China Internet Information Center, source China Daily, Top News Section, June 2, 2003. <http://www.china.org.cn/english/2003/Jun/65988.htm>

outstanding loans which resulted in a sudden chain of bankruptcies among the affected firms.²⁴⁴

The BIS is the principal forum for developing international supervisory standards for banks in both industrialized and the less developed countries throughout the world. BIS relies on market conditions to discipline banks and protect consumers. In the end, national bank regulators have little choice but to implement the recommendations in part or in whole as “global standard” rules. Implementation of the BIS’s recommendation should not be seen as a legal burden, but rather as a necessary requirement to reduce risks and failures in the business of banking. National financial authorities should be especially attentive in developing countries, which need to increase their cooperation in implementing the standards provided by the BIS.²⁴⁵

As financial markets become more and more integrated, bank regulators around the world will be seeing more of each other than they have in the past. Banks operating imprudently and without proper supervision are the ones most likely to mismeasure their risks, misprice their products, and disrupt the markets. Detecting and deterring such institutions does not necessarily require having uniform regulatory or supervisory systems, rather than a certain level of cooperation and coordination and a material level of consistency. Even in countries that have no internationally active domestic banks, authorities need to ensure that the banks operating in their markets are sound and subject to adequate supervision, whether by home or host authorities.

In its deliberations and in the materials that it sends out, BIS and CBS influence

²⁴⁴ See Hwa-Jin Kim, 17 Berkeley J. Int'l L. 61(1999), “Living With the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea.”

²⁴⁵ See Jonathan Ward, Research Fellow at Center for Business Research, Cambridge University, The New Basle Accord and Developing Countries: Problems and Alternatives, Working Paper No. 04, September 2002.

local regulators as well as the banks subject to their supervision. Bank regulators must understand the full implications of their practices for the financial safety of depository institutions..²⁴⁶ Flexibility in implementing the Committee's recommendations may well be more important for bank regulators in developing countries than in industrialized countries with large, developed financial systems. The economies of developing countries are often too weak to adapt BIS or CBS recommendations strictly. However, different situations would normally require different solutions. Accommodating differences does not reduce the need for minimum regulatory or supervisory standards in compliance with sound banking and safety net principles. At the end of the day, it would be up to bank regulators and, as required, to legislators to pass regulations and laws consistent with internationally recognized standards, but always accommodating the local "culture" of doing business and economic needs.²⁴⁷

So far, the BIS's recommendations are serving supervisors and the industry reasonably well as one of the primary tools for maintaining a sound and safe banking system. The nature and complexity of risk, as undertaken by banks and other financial institutions, is making the blunt traditional measures of capital adequacy less meaningful. Considering the

²⁴⁶ Speech by Andrew Crockett, General Manager of the Bank for International Settlements, on the occasion of the Bank's Annual General Meeting in Basle on July 8, 2002. For more information of his speech, visit <http://www.bis.org/speeches/sp020708.htm> (Mon, 08 Jul 2002).

²⁴⁷ See remarks of Roger W Ferguson, Jr., "G-10 Study of Financial Sector Consolidation," Vice-Chairman of the Board of Governors of the US Federal Reserve System, at the Task Force on Financial Sector Consolidation press briefing, held in London, on 25 January 2001. See also Overview Paper for The Impact Study, Basle Committee, October 1, 2002. For more information, visit also the website at <http://www.bis.org/bcbs/qis/qis3ovrv.pdf>

likelihood of the continued modernization of technology, financial authorities are trying to develop ways to improve their control and supervisory role towards banks, while reinforcing incentives for sound risk management of banks activities. The BIS's recommendations help national financial authorities achieve these multiple objectives.²⁴⁸

Implementation of the BIS's recommendations alone are insufficient to ensure international financial stability. Nor are these standards an end in themselves, or some kind of magic "cure-all." Instead, they should be viewed as a means of promoting sound financial systems and, in turn, to sustaining economic growth. One expects that implementation of the BIS's recommendations will, at the least, reduce the likelihood of future international crises of significant proportions.²⁴⁹ The BIS will continue to monitor the activities of banks and other financial institutions closely

CHAPTER V

Need for International Bank Guidelines

²⁴⁸ See Basle Accord II, The New Basle Capital Accord, Consultative Document, Basle Committee on Banking Supervision, April 2003. The accord applies to international capital accord that is based on three pillars: 1) a minimum capital requirements that is more sensitive to risk; 2) a supervisory review process; and 3) market discipline.

²⁴⁹ BIS Quarterly Review, International Banking and Financial Market Developments, Bank for International Settlements publications, March 2001,

The concept of an open market, available to entry and to competition and also subject to failure, is the accepted economic philosophy of today's international economy.²⁵⁰ Regulation has not, however, abdicated its function; the dominant economic problem of our time may be where and how much to regulate both nationally and internationally. This question lies at the heart of the process of state-building in such new governments as Afghanistan and Iraq as well as in re-creations as in Russia. Should there be an S.E.C. equivalent? Should there be an Environmental Protection Agency equivalent? Following major international bank failures over the Twentieth Century, it is generally agreed that it is consistent with the theory of the free market that organizations, particularly banks, be regulated. Degrees of regulation vary with the type of function involved. Whatever benefits apply, for example, to the unrestrained manufacture and sale of sneakers do not necessarily apply to banks. Not only is the general money supply inextricably bound in with the solidity of the banking system, but the financial reserves of the public sector in terms of, for example, lender-of-last-resort exists in tandem with a dependable banking system.

Banks are fundamentally always at risk. It is, in fact, the nature of a bank to be at risk because its dominant business is the loan of money to individuals, companies and governments. A bank's assets are measured by the likelihood that the obligations it holds will be repaid. Its success is measured by the soundness of its financial evaluations of others; by the degree that

²⁵⁰ The failure of the World Trade Organization meeting in Cancun, Mexico on September 14, 2003 was, ironically, the result of some of the world's wealthiest states, including the United States, refusing to subject their agricultural businesses to the international free market. New York Times, Sept. 15, 2003, p.1.

others honor their debts. A bank's assets are not measured in tangible goods but rather almost entirely in the degree to which other parties are true to their obligations. A bank that totally manages to avoid risk is probably not doing a banking business.²⁵¹ On the other hand, a bank that incurs undue risk in its evaluations of others is risking failure. Its security is inherently reduced by the fact that the debts of the bank to others are mostly short term - deposits - while its assets are generally payable over considerably longer periods of time. All banks stand on banana peels. The history of banking has made this evident. A prime function of a bank regulator is to measure and control risk.²⁵² A banking system needs this regulator to function and survive..

Today, all major banks are engaged in international financing activities. Every major bank is an international bank; yet, each bank has a strong domestic orientation. Each bank is a single business entity responsible to senior executives and usually to stockholders with a base in one home country. Bank regulators who affect these banks are, on the other hand, dispersed through the countries in which the bank does its business. Each country has its own system of regulators; each system is organizationally separate from the others. The banks and its regulators do not match each other. There is no centralized control over the international operations of banks.

²⁵¹ During the savings and loan crisis of the late 1970s, some S&Ls reduced their lending activities because of suspect business conditions. They were roundly criticized by their regulators for this unbanklike conduct despite what proved to be a sound business philosophy.

²⁵² In the United States, a bank must achieve what the legal system calls "safety and soundness." To measure this, regulations measure banks under what is called the CAMELS standard. The letters are an acronym derived from Capital, Assets, Management, Earnings, Liquidity and Sensitivity to risk.

As we saw in the late 1990s, banking failure is serious; it is often virtually the equivalent of economic failure. This is because bank failure is often “systemic” in nature and can infect first a country, then a region of the world and then spread to other regions. While it is generally agreed that coordinated banking regulation is in principle a good thing, the nature and quality of that regulation raises difficult and controversial issues. The meeting of the Group of Ten central banks and related bank regulators at Basle is regarded beneficently. The soft law that has emanated from those meetings has been well received and one expects more to come, particularly in the field of capital regulation.²⁵³

Although there has not been anything compulsory about the positions taken by CBS, it has come tantalizingly close to requiring its member central banks to abide in their home countries by its positions and to give formal effect to those decisions. The formal document adopted by CBS in July 1988 as a standard for measuring international bank capital²⁵⁴ provides as follows in the first paragraph:

The present paper is now a statement of the Committee agreed by all its members. It sets out the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the

²⁵³

²⁵⁴ International Convergence of Capital Measurement and Capital Standards, July 1988, 30 I.L.M. 980 (1991).

Committee intend to implement in their respective countries.²⁵⁵

A commentator at the time wrote: “The July 1988 Report clearly envisions some form of subsequent adaptation by national authorities.”²⁵⁶ In 1988, with the Capital Accords, CBS took a clear step in the direction of international bank regulation. We are groping for the next step. Indeed, should there be a next step? Should we be planning now to turn soft law into hard law and create a real, functioning international body of bank regulation?²⁵⁷

CHAPTER VI

Proposals that the Bank for International Settlements Become the World Financial Authority

Institutions, public and private, are created when those in power feel they are necessary.

²⁵⁵ This was a considerably more aggressive posture than that taken in the prior draft of the paper dated December 1987 which in about the same place said: “This paper sets out the conclusions of the Committee’s discussions (reflecting as appropriate important minority views) in the form of a proposal for a common framework of capital adequacy measurement and a common minimum target capital standard to be achieved and maintained by banks operating internationally.” 27 I.L.M. 530 (1988)..

²⁵⁶ Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities*, 49 Ohio S.L.R. 1299, 1347 (1989). At note 249 in the same article, Norton discusses “soft law” and writes “In fact, one author (albeit with minimal supporting authority) characterizes the Committee’s actions as a form of “international administrative law.”“ The administrative law idea was, however, picked up some decade later when, in reviewing CBS,s process, another commentator noted: “This process is similar to the process of administrative rulemaking in the United States.” Tarbert, *Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond*, 148 Pa.L.R. 1771 (2000), n.80

²⁵⁷ It has been predicted that the widespread and basically uniform adoption of soft law will evolve into the ultimate hard law status of CBS. Lee, *The Basle Accords as Soft Law: Strengthening International Banking Supervision*, 39 *Va.J.Int.L.* 1 (1998).

This truism applies to all levels of society, including the community of international financial institutions. The number and magnitude of banking crises in the world over the last decades are impressive. A crisis, when defined as a situation in which the banking system's capital is exhausted as a result of recorded losses, occurred 67 times between 1980 and 1996.²⁵⁸ This figure has since grown substantially higher as a result of the Asian, Mexican, Brazilian, Russian and other major financial crises.

The Asian crisis of 1997 in particular initiated a worldwide reappraisal of international of banks activities. The reappraisal was conducted by banking commentators, international financial institutions (including the International Monetary Fund, the World Bank, the Bank for International Settlements), and most industrialized nations' economic policy forums (the G-7, G-10, etc). This ongoing debate is commonly called "reform of the international financial architecture." International financial liberalization has been costly but with benefits. Costs could have been substantially mitigated if a key lesson had been drawn from domestic financial markets liberal markets are only efficient if they are efficiently regulated. The main task of financial regulation is management of the risks; it must take its appropriate place in the liberalization of financial markets. Without regulation, the risks and the accompanying costs can become excessive.

During the late '90s, a debate took place on what institutional changes were needed to manage current international financial systems. Among the most noticeable alternatives were "leave it to the markets," "create a super-regulator," or employ "step by step initiatives to deal

²⁵⁸ See Caprio and Klingebiel, *Bank Insolvencies: Cross-Country Experience*, World Bank Policy Research Working Paper No. 1620, July 1996.

with particular issues.”²⁵⁹ Advocates of “leave it to the markets,” have argued that the international financial system can run based on every market’s needs; let the financial market run its own course. “Create a super-regulator,” refers to the logic applied by Eatwell and Taylor on the creation of a World Financial Authority²⁶⁰. The philosophy of this approach is that as financial institutions become more global, their regulators and supervisors should also become global. The absence of a global regulator may create problems in maintaining safety and soundness in international financial markets.

_____ In referring to the concept of “step-by-step initiatives to deal with particular issues,” it is argued that countries will adopt international standard initiatives when the market needs them. An example, is the international cooperation on bank supervision that occurred under the guidance of CBS. International rules on capital adequacy originated in a joint proposal by the US and the UK bank regulatory agencies in 1987. Thereafter, this approach was extended to the G10 countries. As a result of the fact that the rules on capital adequacy gained credibility with markets and were also implemented by financial authorities in the major industrialized countries, other countries followed suit. These rules became a global standard not because they were issued by CBS’s initiative, but because an internationally accepted standard was needed.

²⁵⁹ See See Philip Turner, Bank for International Settlements, “Development and the International Financial Architecture,” Overseas Development Institute Meeting Series on Financing for Development. Presentation on 11 April 2001.

²⁶⁰ Eatwell and Taylor, *supra*, note 4, particularly at p. 208 *et seq.*

Among those who have argued for regulation of the international financial market was former President Tietmeyer of the Deutsche Bundesbank (German Central Bank)²⁶¹ who persuaded the G7 to create a Financial Stability Forum that would bring together ministries of finance, central banks, and major supervisory authorities, as well as international financial institutions. The mission of the Financial Stability Forum was to build on existing institutions, which would remain fully responsible for their mandated tasks. It would also attempt to enhance synergies that could be achieved from a better pooling of information and points of view.²⁶²

Proposals on the future of international financial institutions range from a significant enlargement of the powers of the International Monetary Fund to the creation of a new World Financial Authority (“WFA”) to head up all initiatives aimed at financial stability,²⁶³ with intermediary variants such as the merger of the two Bretton Woods institutions and the

²⁶¹ See Tietmeyer, *International Cooperation and Coordination in the Area of Financial Market Supervision and Surveillance*, Report to the G-7 Finance Ministers and Central Bank Governors, February 11, 1999. Emphasizing the role of the BIS in the creation of the Financial Stability Forum, Mr. Tietmeyer states: “The Bank for International Settlements (BIS) provides analytical, statistical and secretariat support for various official groupings [such as Financial Stability Forum] working to strengthen the global financial system ... Support for the Forum would be provided by a small secretariat located at the BIS in Basle. Members of the secretariat could be drawn from the BIS ...”

²⁶² Id.

²⁶³ See Eatwell and Taylor, “International capital markets and the future of economic policy: a proposal for the creation of a World Financial Authority,” 1998, *mimeo* (Ford Foundation).

organization of an international lender-of-last-resort function by the IMF²⁶⁴ or the BIS.²⁶⁵ Even some world leaders, such as British Prime Minister Tony Blair, are calling for a new international financial architecture in the direction of a “New Bretton Woods for the New Millennium.”²⁶⁶ In the U.S., the February 1999 Economic Report of the President stated that (a remarkable statement on behalf of President Bush) “financial liberalization and innovation have rendered national boundaries irrelevant. If regulation was necessary within national boundaries, then it is now (at least) equally necessary in the international market.”²⁶⁷

All these proposals have two characteristics in common. First, they focus on institutional reforms rather than on less ambitious but more pragmatic and rapid initiatives. Second, they concentrate power in one or a limited number of institutions rather than a dispersion of responsibilities.

Regardless of the lessons learned from the history of international financial crises, they

²⁶⁴ See Charles Calomiris, *Blue prints* for a new global financial architecture. Conference on “Asia: an analysis of financial crises,” Chicago, October 1998.

²⁶⁵ See Michel Aglietta and Christian de Boissieu, 1998, “Redéfinir Les Règles du Jeu,” *Sociétal*, No. 23, December 1998, pp. 37-42.

²⁶⁶ See NGLS (United States Non Governmental Liaison Services) Roundup, No. 38, July 1999, “DEMOCRATIZING GLOBAL FINANCE: CIVIL SOCIETY PERSPECTIVES ON PEOPLE CENTERED ECONOMICS ,”

²⁶⁷ Ralph Bryant (1987), “International Financial Intermediation,” Washington, DC: Brookings Institution.

remain unpredictable. Realistically, reforms should be organized around a cautionary principle and should contain market failures when they occur. The key role of large international banks should be more carefully supervised since the banks can transmit market discipline to their debtors. Large banks with failing internal control systems would be subject to corrective measures at an early stage. In this respect, the WFA would have a key role in obtaining the necessary cooperation among national supervisors.

With respect to international crisis management, there is a need for an international “lender of last resort” who could intervene in the market if the risk of crises becomes endemic. It seems that a structured cooperation between central banks and the WFA should be part of any plan.²⁶⁸

Eatwell and Taylor have proposed the establishment of an international financial institution, called the WFA, which would perform the functions of a world financial market similar to those of national regulators function in domestic markets.²⁶⁹ They further suggest that the WFA should be built upon the foundations for global financial surveillance and regulation,

²⁶⁸ 14, Instability of the International Financial System
Report Olivier Davanne Discussants Michel Aglietta, Patrick Artus and Christian de Boissieu,
See Conseil d’Analyse Economique, see
http://www.archives.premier-ministre.gouv.fr/jospin_version2/GB/PM/CAE/REPORT14.HTM.

²⁶⁹ See Eatwell and Taylor, *supra*, note .

which are already provided by the BIS.²⁷⁰ They argue that we need a fundamental restructuring of international financial institutions and propose the establishment of a WFA as an independent institution to perform activities in the world financial markets, similar to what national regulators do in the domestic financial markets.²⁷¹ An effective WFA should have the ability of any domestic regulator.

The WFA would develop analysis of markets and policies, further enhancing the efficiency of international finance.²⁷² Resulting from breakdowns in national regulatory capacities, as liberalization spreads worldwide, there is a need to monitor high and variable real interest rates, volatility of asset prices, poor national economic performances and the contagious spread of market instabilities worldwide. These developments could create the possibility for massive upheavals even in the large and integrated financial markets of the industrialized states. The WFA could be the right institution to monitor and coordinate these crises.²⁷³ The WFA could also handle currency crises and speculative schemes of exchange rates in developing and transition economies, which are normally associated with rapid capital market liberalization and

²⁷⁰ Paul De Grauwe (1987), "International Monetary Policy," in John Eatwell, Murray Milgate and Peter Newman (eds.).

²⁷¹ See *infra*, note 62.

²⁷² See John Eatwell (1994). "The coordination of macro-economic policy in the European Community", in John Grieve Smith and Jonathan Michie (eds.), *Unemployment in Europe*, London: Academic Press.

²⁷³ See John Eatwell (1997a), "International Financial Liberalization: The Impact on World Development," Discussion Paper Series, no.12, Office of Development Studies, New York: UNDP.

the absence of appropriate regulatory procedures designed to deal with the flow of capital.

Because of the prospect of major financial crisis in the future, the WFA may well become politically feasible. If that happens, it is important to have given advance thought to how the WFA would actually work. Taking preparatory and preventive measures, makes it possible to minimize the spread of financial crisis in other economies, as well as to lessen the impact of these crises internationally.²⁷⁴ Other components of the WFA's functions would be the control and accountability of the management of risk, macroeconomic policy and industrial policy, all of which can stimulate efficient operation of financial markets. This becomes particularly clear in periods of relative deregulation when the authorities lose control of credit and a speculative financial bubble first inflates and then bursts. Examples are the Japanese financial market crisis early in the 1990s and the US savings and loan crisis around 1980.²⁷⁵

In the global economy, the WFA's central role would be to cure inefficiencies in the financial marketplace that are outside the jurisdiction of any one country but not outside the jurisdiction of the society of nations.

²⁷⁴ See John Eatwell, "Unemployment: National Policies in a Global Economy," Queens' College Cambridge, 2000, For more information, go to "at www.newcastle.edu.au/faculty/bus-law/centres_groups/esc/conferen/John%20Eatwell-article1-2.doc"

²⁷⁵ See Stephen Marglin and Schor Juliet (1990), "The Golden Age of Capitalism. Oxford: OUP."

There have been increasing attempts to forge cooperation among financial regulators to accomplish this global task. As global financial markets have achieved greater integration so cooperation among financial regulators has consolidated into regular coordination. An international WFA would make these relationships more effective.²⁷⁶ The growth of a world financial market has created interrelationships we only begin to understand and risks we can barely imagine. The benefits of a WFA, with all regulatory and supervisory powers concentrated at the world level, are increasingly perceived.²⁷⁷

A WFA should be given the power to guide and dictate to national financial markets. Obviously, this can be achieved by blessing the BIS with enforcement and authoritative powers. But how these powers can be entrusted to the BIS remains a challenging task. A supreme global regulatory body should have the power to impose mandatory sanctions for violation of its edicts and even to oversee such global financial institutions as the International Monetary Fund and The World Bank. At present, there is no systematic evaluation of the activities of the Bretton Woods' institutions; yet their operations are regularly subject to severe criticism. BIS, albeit a source of less than binding law, has begun this task and can serve as a step towards creation of a WFA.

²⁷⁶ See Robert Shiller (1988), "Causes of Changing Financial Market Volatility," in Federal Reserve Bank of Kansas City, Symposium.

²⁷⁷ See Ajit Singh, "Openness and the Market-Friendly Approach to Development: Learning the Right Lessons from Development Experience," World Development, 1994.

As the shape of the WFA evolves it can be related to the operations of securities and futures markets, hedge funds, foreign currency traders, fund managers and other institutions that use borrowed money for speculative purposes, therefore avoiding or reducing destabilizing leveraged activities and systemic bank risk.²⁷⁸ Making international financial institutions accountable to the WFA would introduce a “safety valve” consisting of evaluation and accountability.²⁷⁹

The WFA would quite naturally assist national bank regulators in improving their regulatory and control functions with respect to their national financial systems (by way of example, through the imposition of capital and/or reserve requirements on all major banks and financial institutions). The WFA should ensure that the capital control programs implemented in one country are consistent with such programs in other countries of the same region, thereby preventing one country from attracting finance capital at the expense of its neighbors. In many countries, the WFA might simply certify that domestic regulatory procedures are effective. In others, the WFA would assist with regulatory reform.

The WFA would provide a forum in which rules of international financial cooperation are developed and implemented by national financial authorities. The WFA will fill the gap in the

²⁷⁸ See Roy Culpeper, “Systemic Reform At A Standstill: A Flock Of "Gs" In Search Of Global Financial Stability,” G-8 Scholarly Publications and Papers, 2001.

²⁷⁹ See Institute of International Finance (2000) “Leading bankers make major proposals to strengthen the international banking system.,” Press release, The Hague, April 12, 2000.

current limited means for achieving such coordination among financial authorities. The WFA also will be responsible for ensuring that once policies have been agreed upon, the national financial authorities support each other.²⁸⁰ WFA must supplement the present function of the IMF in developing a credible and effective guarantor and lender of last resort.

Recent decades of international financial liberalization have removed almost all distinctions between national and international capital markets. In the event of a rapid development of financial markets, the same regulatory tasks required in national markets will be needed internationally. The BIS was the first institution to create international financial regulation with the formation of the Committee on Bank Supervision and Regulation in 1975. It formulated the bank capital adequacy requirements in the 1980s which all members of the BIS agreed to observe and to bar from their markets foreign banks not adhering to the requirements.²⁸¹ More countries have voluntarily agreed to BIS standards in order to achieve market credibility.²⁸²

²⁸⁰ See Stephany Griffith-Jones and Kimmis Jenny (1999), "The BIS and its Role in International Financial Governance," in *International Monetary and Financial Issues for the 1990s: Research Papers for the Group of 24*, Vol. XI (New York: United Nations).

²⁸¹ See John Eatwell and Lance Taylor, "The Performance of Liberalized Capital Markets," August 1998, revised September 1998, *International Capital Markets and the Future of Economic Policy* No. 8.

²⁸² See Mark Weisbrot, "Globalization A Primer," Center for Economic and Policy Research, October 1999.

Existing international institutions are not up to the task of regulating the global financial system. This is due to such factors as a gap between effective regulation and “bail-outs,” a vital precondition for the effective minimization of moral hazard; inadequate surveillance powers; and a still incomplete definition of capital requirements and best practice risk management techniques. The International Monetary Fund and the World Bank were set up to handle, respectively, the balance of payments and economic/financial development problems worldwide. Due to the restricted focus of each, however, they do not seem to be the right organizations to deal with today’s international financial markets. Increasing consideration is being given to a new WFA. and BIS seems the logical source.²⁸³

The proposal for the creation of a WFA appears motivated mainly by two arguments. First, since financial businesses are becoming increasingly interrelated and cross-border, their regulation and supervision should also be carried out on a unified and global basis. Second, the stability of capital movements is now subject to a patchwork of regimes, which could only be controlled by more uniform regulation. Various models for a WFA can be envisioned, spanning the spectrum from an institution built on existing arrangements to one with more comprehensive responsibilities.²⁸⁴

²⁸³ See NGLS (United Nations Non Governmental Liason Service) Roundup , No. 38, July 1999, “Democratizing Global Finance: Civil Society Perspectives on People Centred Economics”; Corbin Cowley, “International Monetary Fund Reform,” *Hinckley Journal of Politics*, Spring 2000, Vol. 2, No. 1.

²⁸⁴ See Yilmaz Akyüz and Andrew Cornford, (1994), “Regimes for International Capital Movements and Some Proposals for Reform,” UNCTAD (United Nations Conference on Trade and Development) Discussion Papers, no. 83.

There is considerable support for strengthening national regulatory regimes and improving cooperation among the national authorities already in existence. A newly-created WFA would, of course, have to confront the problem of reconciling and integrating the different legal and conceptual frameworks under which national supervisors from different backgrounds work. Moreover, there is no compelling reason that a WFA would be more successful than existing international agencies (e.g., International Monetary Fund) in achieving global stability. A network of institutions, albeit imperfect, is already in place, and there can be benefits from strengthening the network, and extending its mandate in certain areas as greater participation is assured and its governance improved.²⁸⁵

The creation of a new body with senior responsibility for setting regulatory standards for all financial enterprises worldwide would be an almost unreasonably ambitious approach. National regulators would remain responsible for implementing its standards and the function of the new institution would be largely one of surveillance, although it expected to act as a brake on a country's capital influx. A less ambitious approach would be for the WFA to serve simply as an umbrella organization under which existing local or national bodies would operate.²⁸⁶

²⁸⁵ See report "The Financial Crisis and Its Impact on Growth and Development, Especially in the Developing Countries," United Nations, General Assembly, October 27, 1999. For more information, see, <http://www.google.com/search?q=cache:kbpeZ6gLGn0J:iml.umkc.edu/econ/economics/faculty/Kregel/Readings/a54512a1.pdf+%22WORLD+FINANCIAL+AUTHORITY%22&hl=en&ie=UTF-8>

²⁸⁶ The Financial Stability Forum consisting of representatives from the finance ministries, central banks and senior regulatory authorities of the G-7 countries as well as from the

International financial supervision, a global WFA, would be necessary in either case for the survival of an efficient liberal international system.

As the ultimate worldwide financial authority without accountability, there is the danger that a WFA would be so singly focused to prevent financial crisis that it would set an excessive regulatory burden. There would be - but on a global scale - the problem already faced with local regulators: overregulation, with the consequence that the world community would pay the cost of stymied competition, absence of innovation and product stultification. This is, of course, both on the national and international level a well-known existing problem. Regulatory agencies in the United States are routinely criticized for abusing their powers. Internationally, the IMF is regularly accused by both consumer and industry groups of demanding sacrifices that recipients of its largess cannot deliver. It is accused of eliminating public financial benefits and destroying the environment among many other perceived derelictions.

Furthermore, would a WFA be able to assess risk in every corner of the world better than the local regulatory authority? What would be the legitimacy of such an institution relative to national regulatory bodies that respond directly to national parliaments and ultimately to voters? Would it not be unmanageable to administer regulation and supervision to the global

IMF, the World Bank, the Basle Committee on Banking Supervision, IOSCO, the International Association of Insurance Supervisors (IAIS), the Bank for International Settlements, the OECD, the Committee on Payment and Settlement Systems, and the Committee on the Global Financial System (formerly the Euro-Currency Standing Committee) is arguably of this kind. Objectives include pooling and sharing of information on vulnerability in the international financial system among different bodies, and some kind of monitoring of the implementation of internationally agreed regulatory and supervisory standards and codes of conduct.

financial system? Finally, would a WFA be politically acceptable? Even within the confines of a homogeneous group like the European Union, financial regulation and supervision remain at the national level. It is argued that oversight and supervision must be a very hands-on affair. At least, this was one of the arguments used in Europe when it was decided that banking supervision would stay at the national level rather than migrating to the European Central Bank.²⁸⁷

These are known problems without a known solution. To the extent that a solution exists, it is in the construction of the enterprise; a system of checks and balances that gives the WFA sufficient authority to do its job but also enables its leaders to be changed if they abuse their positions.

Generally speaking, there are various proposals for world financial reform, ranging from suggestions for pre-emptive crisis mechanisms to recommendations for the reform of the International Monetary Fund to several proposals for establishment of a WFA. However, three main proposals have been given serious attention.

One is the logic applied by Eatwell and Taylor to a WFA, which (as do many arguments based upon economic reasoning) seems impeccable. It faces at least one insuperable obstacle. At the present time, the US does not seem to have any intention to cede any regulatory sovereignty to a WFA. Rather, as the country with the largest and deepest capital markets, it is more likely to

²⁸⁷ See Michele Fratianni and John Pattison, "International Financial Architecture and International Financial Standards," *The Annals of The American Academy of Political and Social Science* January, 2002.

extend its own system of regulation to the world. If every financial entity requires a quote on Wall Street in order to raise capital on level terms with U.S. corporations, then necessarily they must adopt U.S. accounting rules and subscribe to U.S. regulation.²⁸⁸ The U.S. position is that the current financial architecture is sound; therefore, there is no need for major financial reform. Whatever reform is needed is seen simply as a question of improving the system's wiring.²⁸⁹

This approach, "the wiring not the architecture," gives primacy to "reforming" financial sectors along the lines of more transparency, tougher bankruptcy laws, prudential regulation using BIS recommendations, and encouraging more foreign capital to recapitalize shattered banks as well as to "stabilize" the local financial system by making foreign interests integral to it.²⁹⁰ As a consequence, it would be advantageous for the BIS, short of being a formal and central regulator, to play a key coordinating role in rapidly assembling financial packages by G-10 Central Banks, combined where feasible with private credit lines for countries in currency crises

²⁸⁸ See Will Hutton, "America's Global Hand," *The American Prospect*, Volume 11, Issue 2, December 6, 1999.

²⁸⁹ *Among the documents that broadly share this view are the following: Group of 22, "Reports on the International Financial Architecture, Working Groups on Transparency and Accountability, Strengthening the Financial System, and International Financial Crises," October 1998; Morris Goldstein, The Asian Financial Crises: Causes, Cures, and Systemic Implications (Washington: Institute for International Economics, 1998); Robert Rubin, "Strengthening the Architecture of the International Financial System," Speech at the Brookings Institution, Washington, D.C., April 14, 1998; Stanley Fischer, "On the Need for an International Lender of Last Resort," Paper prepared for the American Economic Association and the American Finance Association, New York, January 3, 1999; and Barry Eichengreen, Toward a New International Financial Architecture (Washington, D.C.: Institute for International Economics, February 1999).*

²⁹⁰ See Waldon Bello, "Do not Let Global Elites Devise Financial Architecture," Editorials & Opinions, *The Nation*, March 23, 1998.

not caused by the countries' policy mistakes and not requiring changes in policy.²⁹¹ There would be countries the BIS operating in its present mode (or perhaps the related CBS) deemed to be well managed. . If these countries had a run on their currency, and a crisis started to unfold, a non-conditional financial package could be assembled by BIS, drawing possibly on its own resources, but mainly on those of most industrialized central banks and, if feasible, on private lending.²⁹²

There would also be countries that during consultations with BIS might agree to a “shadow program” of conditionality something like the demands currently made by the IMF. If local authorities implemented the program fully, and a crisis still broke out, BIS would disburse financial aid automatically. If a bigger package was necessary, the BIS could help coordinate additional financing from most industrialized central banks and big private banks.

There would still be countries that would not want to accept a “shadow program” with the BIS and would not improve their economic policies. If these countries were hit by a currency crisis, they would have to go to BIS for conditional lending, as a first step.

²⁹¹ See Stephany Griffith-Jones, “A New Financial Architecture For Reducing Risks and Severity of Crises,” Friedrich Ebert Stiftung, Politik und Gesellschaft Online, International Politics and Society 3/1999.

²⁹² IMF. 1998. *Toward a Framework for Financial Stability*, Prepared by a Staff Team led by David Folkerts-Landau and Carl-Johan Lindgren (Washington, International Monetary Fund).

Such a procedure would provide strong incentives for countries to have sound policies and decrease the likelihood of crises . However, if crises occurred, then large lending by facilities of the BIS and/or lending by central banks and commercial banks coordinated by the BIS would take place quickly and without additional conditionality.²⁹³

The purpose of redefining the role of international financial institutions and pertinent regulations is that, unfortunately, financial markets are not thoroughly rational and risk-free in the international financial system. The debate on the “architecture” of the international financial system has generated various proposals to redefine responsibilities among international institutions and sometimes to create new bodies. We believe that the niche now occupied by BIS can, with continued fine-tuning, start to serve this purpose. To retain the image, we can continue to use the present architecture; we don’t have to build a new building.

Nevertheless, proposals addressing the role of a WFA in financial crisis management have some logic.²⁹⁴ Globalization of markets inevitably opens the debate about the usefulness of a global regulator, such as a WFA, which would set standards, monitor their

²⁹³ Stiglitz J. 1998b. *The Role of International Financial Institutions in the Current Global Economy*. Address to the Chicago Council on Foreign Relations, February 27 1998, Chicago. <http://www.worldbank.org/html/extdr/extme/jssp022798.htm>

²⁹⁴ See William R. White, “New strategies for dealing with the instability of global financial markets,” *Conference “The management of global financial markets,”* Budapest, June 1999.

implementation, supervise the functioning of international financial markets and take preventive action.

As financial markets become more global, the influence of increasing numbers of countries with their own laws and practices creates a more diverse system. This in turn raises the issue of harmonization of standards and regulations and good communication among supervisors. Regrouping responsibilities could generate synergies and favour unity of vision and concept in the regulation and surveillance fields, similar to the objectives assigned to national financial regulatory authorities.

Clearly, establishing an international consensus on such far reaching reforms is extremely ambitious. National financial authorities would have to give up a significant part of their current responsibilities. It is unlikely that national financial authorities would unanimously agree to such transfer of authority. Such a change would have to be reached gradually and over the course of time. Reaching agreement on fundamental adaptations at the international level, where each participant remains sovereign, is feasible - but not now..²⁹⁵

Another question pertaining to the concentration of powers is whether the advantages of common international understandings can be achieved in the context of large financial institutions and wealthy, self-absorbed states already accustomed to deal with complex

²⁹⁵ See Steven Radelet and Jeffrey Sachs, "What have we learned, so far, from the Asian financial crisis?," *mimeo*, Harvard Institute for international Development, January 1997.

issues on their own behalfs. Big per se is not always beautiful and efficient. Unwieldy procedures are a real risk and internal difficulties could be more damaging to the international community than a continuing debate on competencies among independent financial institutions. There is also a risk that large supranational financial institutions, such as a WFA, could progressively lose touch with the reality of markets.²⁹⁶

Often, it is perceived that a WFA could turn out to be a “mediocre regulator,” able to deal only with common denominator problems and proposing regulation that would not be adapted to and would prove insufficient in various economies and financial markets. This is a view already widely held about the World Bank and the IMF. Concerns of this sort might force a WFA into a closely regulated organizational structure. If members of a WFA individually retain the responsibility of adjusting decisions to their market needs, the new structure would not represent any particular advantage over the existing BIS..²⁹⁷

A WFA as an international lender-of-last-resort raises both theoretical and political questions. A lender of last resort injects liquidity into the market or into individual financial institutions in order to avoid a transitory funding problem with systemic implications. A WFA would require either standby funds for this purpose or a means for raising them at short

²⁹⁶ See speech of Hans Tietmeyer at the “*Systemic risk and lender of last resort*” Conference, Center for Financial Studies, Frankfurt, June 1999.

²⁹⁷ See a Report on the September 2002 Task Force Meeting by the Capital Market Liberalization Task Force of the Initiative for Policy Dialogue, Notes Taken by Columbia University SIPA students; Edited by Alex Cobham.

notice from its members or elsewhere. Also required would be an available method for converting funds into the particular currency required..²⁹⁸

The international financial scene changes very rapidly under the influence of innovations, the globalization process, and the emergence of new actors. There is, therefore, a risk that at the end of a long financial institutional reform, the result would not fit the realities of the moment. Small and progressive reforms are better suited to our changing environment than an ambitious transformation like the creation of a WFA.²⁹⁹ When confronted with large risks of financial instability of a potentially systemic nature, national financial regulators are now expected to take concrete and rapid measures aimed at strengthening the financial system. Until a WFA becomes realistic, greater safety is achieved institutions that exist.³⁰⁰

Arguments in support of a WFA include the globalization of financial markets, the breakdown of sectoral distinctions worldwide (among banks, investment dealers, insurance companies and asset management firms), the growing integration and complexity of international financial markets, and the need for efficient information sharing by all relevant bodies. These are

²⁹⁸ See Forrest Capie, "Can there be an international lender-of-last resort?," *International Finance* 1:2, 1998, pp. 311-325.

²⁹⁹ See Anna Schwartz, "Time to terminate the ESF and the IMF," *Cato Institute, Foreign Policy Briefing*, No. 48, August 1998.

³⁰⁰ See speech of André Icard, "Strengthening financial stability: institutional approach or pragmatic multitherapy?," the Federal Reserve Bank of Chicago, 2 October 1999 and published in "Global Financial Crises: Lessons from recent events", BIS and Federal Reserve Bank of Chicago.

both comprehensive and fundamentally international and necessitate a strategy fostering international stability.³⁰¹ At the practical level, national supervisory authorities must oversee and supervise the national financial system in a very hands-on manner. This was one of the arguments used in Europe when it was decided that banking supervision would stay at the national financial level rather than going to the European Central Bank. One could ask whether the magnitude of the task faced by a single worldwide agency might be so great as to call for a similar strategy - supervision at the national level.

Objections to a WFA are significant. As a matter of principle, national regulators and legislators are not yet ready to give up their powers to a single WFA with authority to set standards and enforce them globally. Such a step would be widely perceived as a loss of sovereignty. Local powers are ceded to existing international organizations, not excluding the United Nations, only with pain. Congress' antipathy to the International Monetary Fund and the World Bank makes it difficult for these institutions to obtain US contributions. These attitudes will not change soon. However, national legislators must see that, as financial markets become more globalized, the more authority they retain at home, the more difficult it will be to maintain any measure of authority over what occurs abroad.³⁰²

Internal governance and market discipline should be at the heart of financial

³⁰¹ See Kiichi Miyazawa, "Towards a New International Financial Architecture," Speech at the Foreign Correspondents Club of Japan, December 15, 1998.

³⁰² See Stephany Griffith-Jones, "Global Capital Flows, Should They Be Regulated?," London, MacMillan, 1998.

oversight with the supervisory apparatus playing a complementary and consistent role. A WFA could of course operate in this fashion but it might as it evolves and matures well be tempted to act in its own interests instead. That might imply growing recourse to traditional directives and less reliance on market processes.³⁰³ Immediately after the Asian crises of 1997 -1998, there were widespread calls for a fundamental reform of the international financial architecture. Many argued that the traumas of South Korea, Indonesia and Thailand pointed to fundamental weaknesses in the international financial system. These were countries with relatively sound fiscal positions, enjoying rapid economic growth. However, when a crisis of confidence hit their financial systems, they collapsed quickly. Such an experience, which caught the international financial institutions by surprise, demonstrated not only the inadequacy of financial institutions' surveillance, but also their lack of crises management tools. Though it is fair to say that the financial markets also did not see the crisis coming.³⁰⁴ Experience strongly suggests that the world is not ready for a WFA.

International financial liberalization plus geometric advances in technology have caused financial markets to become closely integrated. These markets can no longer be controlled by policies formulated purely at the national level with their international aspects left unregulated. In order for countries to enjoy the benefits of a flexible international financial system, capable of mobilizing capital on a large scale for the promotion of growth and employment, a structure must

³⁰³ See William R. White, "What Have We Learnt From Recent Financial Crises And Policy Responses?," BIS Working Papers, No. 84, January 2000.

³⁰⁴ See David Pearce, "Making Globalization a Positive Force for Sustainable Development," Commonwealth Consultative Group on Environment, February 12, 2002.

be devised to protect both national economies and the wider world economy from the risks which financial liberalization brings.

The objectives of national financial authorities are to protect consumers with the highest possible standards of integrity, to supervise market conduct, to hone professional skills and to minimize systemic risk. These objectives should be the goal of an international financial regulation structure. As the Chairman of the US Federal Reserve Board, Alan Greenspan, has argued, “a global financial system . . . is not an end in itself. It is the institutional structure that has been developed over the centuries to facilitate the production of goods and services.”³⁰⁵ A financial system is efficient if it achieves that end

There have been proposals, both within international financial institutions such as the International Monetary Fund and the World Bank and also from individual countries to design a new kind of international financial architecture. The fact is that no major new financial institution has been set up, yet. A development worth noting is the creation of the Financial Stability Forum, which was established as an independent organization in 1999³⁰⁶ thanks to initiatives taken by governments of the most industrialized countries (G-7). The Forum brought together financial regulators and central bankers to monitor financial stability worldwide and to exchange information and establish common assessments of vulnerabilities within the

³⁰⁵ Greenspan, “The Globalization of Finance,” Keynote Address at the Cato Institute’s 15th Annual Monetary Conference on October 14, 1997, published in the Cato Journal, Vo. 17, No. 3, Winter 1998.

³⁰⁶ See web site.

international financial system. Regardless of its impressive mission, the Forum does not hold any decision making power even over its member governments (national financial regulators) or over any international financial authorities. Therefore, it is difficult to consider it even as one step in the direction of a WFA.³⁰⁷

There is need for unified global regulation of the financial sector. Meaningful and prudent regulation should enhance international trade and finance, moving the world to a higher state of prosperity..³⁰⁸ The senior regulator should maximize financial stability between the developed and the emerging markets in such a way as to maximize world productivity. None of the current international institutions fits the proposed model as well as the BIS. The BIS is very likely to increase its role as an important center for setting standards in the field of international financial stability. Perhaps, as the BIS continues to run its own course of business, it may ultimately take the role of a WFA.³⁰⁹ Eatwell and Taylor's message is cogent:

³⁰⁷ See Howard Davies (Chairman of the Financial Services Authority, UK) speech, "Is the Global Regulatory System Fit For Purpose in the 21st Century, ?" at the Monetary Authority of Singapore Lecture 2003, Singapore, May 20, 2003.

³⁰⁸ See Farhad F. Ghannadian, *The Coming World Financial Crisis: More or Less World Regulations?*, Mercer University - U.S.A.

³⁰⁹ The Meltzer Report recommends that the BIS (through the various committees) 'remain a financial standard setter. Implementation of standards, and decisions to adapt them, should be left to domestic regulators or legislatures.' The Meltzer Report was published in March 2000 by the International Financial Institution Advisory Commission established by the Congress to consider the future roles of 7 international financial institutions, The International Monetary Fund (IMF), the World Bank Group, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the World Trade Organization (WTO), and the Bank for International Settlements (BIS).

“[T]he WFA is needed because three decades of international financial liberalization have removed almost all distinctions between national and international capital markets. If liberal finance is to thrive, the same regulatory tasks required in national markets are now needed internationally. That is why the BIS pioneered international financial regulation with the formation of the Committee on Bank Supervision and Regulation in 1975. It was that Committee which formulated the capital adequacy requirements for banks in the 1980s to which all 13 then BIS members agreed to observe, and to keep out of their markets foreign banks not adhering to the requirements. The result was that more countries signed on to BIS standards in order to achieve market credibility.”³¹⁰

· CHAPTER VII

· Proper Development of a WFA

In 1997, Professor Raj Bhala of the William and Mary Law School wrote³¹¹:

“BSC (in this article CBS) operates on a tenuous foundation. It is highly unlikely that the G-10 countries will confer jurisdictional authority upon the BSC (CBS). Allowing the BSC (CBS) to write banking law would threaten each country’s sovereignty.”

³¹⁰ See Eatwell and Taylor, “Why We Need a World Financial Authority,” Center for Economic Policy Analysis, New School University, Volume 2, Spring 1999.

³¹¹ Bhala, *Equilibrium Theory, the FICAS Model, and International Banking Law*, 38 Harv.Int.L.J. 1, 15 (1997).

We agree with Professor Bhala's conclusion in its application to CBS and believe that it is equally applicable to its affiliate, BIS. BIS was created in 1923 with not thought of international bank regulation; CBS was created in 1975 when the thought of increasing international regulation had begun to achieve a measure of respectability. Neither is, however, yet ready to assume the mantle of international bank regulator. The banking systems of the world are highly divers and the national regulatory systems reflect the diversity.³¹² One system of regulation cannot today encompass all the realities of bank operation and, perhaps even more important, as Professor Bhala rightly suggests, countries are not ready to abandon their sovereignty in favor of group of experts who meet in Basle, Switzerland.

As we have written, we do not question the desirability of, perhaps even the need for, cohesive and uniform regulation of the world's financial systems.³¹³ Ideally, capital should be measured in the same way and liquidity should be considered from the same perspective in all countries that compete for the same currencies. Level-playing-fields from a regulatory standpoint are desirable for all the world's banks. The inequities and the risks that result from today's bifurcated world of banks is apparent. The international banking crises that resulted from the Asian problems of 1997 exemplify massive systemic problems that are attributable in large part to different banks reading from different regulatory pages. Increasingly the international system calls for a single regulator.

Messrs. Eatwell and Taylor have written:

³¹² In the United States there are different regulatory structures for national banks, state banks, national savings banks and state savings banks and a host of bank-related institutions like mortgage companies, trust companies, finance companies and more.

³¹³ The interrelationship of international banks and the risks created by unequal standards are eloquently presented in Tarbert, *supra*, note 4 at 1778-81.

“We proposed the establishment of a World Financial Authority (WFA) to perform in the domain of world financial markets what national regulators do in domestic markets. A natural place to build the WFA is on the foundations of global financial surveillance and regulation that have already been laid at the Bank for International Settlements in Basle.”³¹⁴

Similarly, Mario Giovanoli, General Counsel for BIS, has written that the “current process of consensus-building through committees of national experts” should be worked upon and “might benefit from some degree of harmonization and streamlining,” moving in the direction of a senior international regulator.³¹⁵

BIS and CBS and their formal and informal affiliates are hardly the only institutions that have assumed some measure of international regulatory control in both banking and non-banking. There are, of course, a number of international organizations without formal government sanction in the financial and financially related areas. We have mentioned some of these. They include, in addition to C BS, the International Organization of Securities Commissions and the International Association of Insurance Supervisors, one of the newer organizations which first met in 1994. Their area of activity has been called “the world of financial oversight.”³¹⁶ We might also mention the international regulation of essentially non-financial affairs through such organizations as the World Trade Organization, the International

³¹⁴ Eatwell and Taylor, *ibid*, p. x.

³¹⁵ A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting, Giovanoli, Ed. (Oxford 2000), p.56. Even Giovanoli acknowledges, however, that “the emergence of a supranational body would appear in any case to be rather unrealistic in the near future.” p.56.

³¹⁶ Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 *Tex.Int.L.J.* 281. 285 (1998).

Atomic Energy Agency, the Marine Fish Conservation Network, the World Health Organization, the International Institute for Environment and Development, the International Council for the Conservation and Restoration of Monuments and Sites and the developing regulation of pharmaceuticals.³¹⁷ All reflect the general awareness that the world is smaller, that it is interrelated and that international problems need international solutions.

A telling example of international financial cooperation occurred during the so-called “debt crisis” of the 1980s. Mexico was the first country to announce that it would be unable to pay its obligations to foreign banks. Cooperative action averted the crisis was largely by means of financial infusions by the United States Federal Reserve and central banks of western Europe and Japan. Each country recognized its own vulnerability and the risks posed by a Mexican default to its own banks. The international community saw an international problem and acted collectively.³¹⁸

Movements towards international accord in various areas are under way and we can learn from them. The United Nations sub-group that deals with international private law, titled the United Nations Commission on International Trade Law (“UNCITRAL”), has, in addition to its many other tasks, been working to harmonize international insolvency law since 1994. In 1997, it produced a Model Law on International Insolvency only by dint of a general agreement within UNCITRAL that it would attempt to address only some four subjects out of the scores that constitute most local insolvency laws. In general, UNCITRAL abided by the principle that the more complex a subject is, the less it is likely to be resolved on an international basis. Since

³¹⁷ The International Conference on Harmonization of Technical Requirements for Registration of Pharmaceuticals for Human Use, Contrera, *The Food and Drug Administration and the International Conference on Harmonization*, 8 Houston J.Int'l L. 665 (1995).

³¹⁸ Krugman, *supra*, note ..., pp. 89-90.

adoption of the Model Law, UNCITRAL has attempted to move forward in harmonizing international insolvency law but has succeeded only in adopting a draft set of general principles for drafting a single international bankruptcy law.³¹⁹ Any consideration of CBS as a single international bank regulator would certainly have a similar fate.

The prestige that BIS has achieved in the international banking arena is undeniable. Chapter III above demonstrates the range and significance of the issues on which it and its colleagues in Basle - the most prestigious of which is CBS - have opined and Chapter IV shows that their opinions are not only taken seriously but also generally adopted by the major banking countries of the world.

CBS has evolved through the years. It is clearly the senior international voice in bank regulation and has been found acceptable throughout the world for several reasons. First, representatives of the major central banks are represented in CBS and, as in England, where the central bank does not have the power to regulate,³²⁰ the institution given that power also has a voice with CBS.³²¹ Each country has the ability to modify the CBS statements to suit its own banking structure and finds CBS acceptable as a central voice for that reason. No country is required to accept the views of CBS. It produces, as we have already said, "soft law." CBS has gradually become the voice of reason as a result of its own sophistication and insight. When a country accepts a CBS opinion, it is not surrendering its sovereignty; it is exercising it.

³¹⁹ Draft Legislative Guide on Insolvency Law, July 14, 2003.

³²⁰ Bank regulatory power is held by the Securities and Investment Board, created in 1997.

³²¹ "Countries are represented by their central bank and also by the authority with formal responsibility for the fundamental supervision of banking business where this is not the central bank." BIS website; www.bis.org/bobs/aboutbobs.htm.

Soft law promulgated by BIS or CBS is widely adopted by the international banking community. It represents movement in the direction of a single international hard law. It is, however, still far from single regulation of the sort that is widely desired and offered by some as a requirement for a healthy international banking system. Individual countries continue to have local authority as to whether to adopt soft law. They may adopt it in different manners as adapts to their local societies. They may adopt some and reject some. We do not at this time have international uniformity.

Conflicts in banking are too great for there to be a single international regulator. We need name only a few:

1. What should a bank do, or, rephrased, what is banking? Different countries define banking in different ways (or don't bother to define it at all). In the United States, the Supreme Court has acknowledged that the definition of banking, or of what a bank may do, will necessarily vary from time to time.³²² At the same time, the United States tends to have a more restrictive concept of banking than do other major countries where a bank may own and operate industrial companies.
2. As a consequence of its narrow definition of banking, the United States has a complex system of bank holding company regulation. The concept is to prescribe a set of activities that are financial in nature but still may not be banking itself. These are included within a set of corporations that are affiliated with a bank but are not necessarily given as powers to the bank itself. No other country regulates its banking system in this manner. To give regulatory power over the world of options to one central regulator would probably grind the regulatory gears to a halt.

³²² *Nationsbank of North Carolina v. Variable Annuity Life Insurance Co. (Valic)*, 513 U.S. 251 (1995).

3. Different countries regulate different types of institutions within their banking structures. The United States presents the most complex regulatory pattern of all with commercial banks, savings banks, savings and loan associations and credit unions as the prime banking - or bank type - institutions, each with its own regulatory structure multiplied by two because of the unique federal/state dual banking system. Then there are numerous institutions close to banks like finance companies, industrial banks and trust companies to name just a few. They too have regulatory structures.

4. Banking institutions offer different products, both financial and non-financial, in different countries. For example, while important compromises have been reached, there is no general agreement within the United States on the extent to which securities activities and insurance should be deemed a part of banking and should be offered by banks.³²³ The Gramm-Leach Bliley Act of 1999³²⁴ has authorized bank holding companies - but not banks themselves - to offer a full range of securities and insurance products and services. At the same time, banks themselves may offer a narrower range of these same products and services.³²⁵ Intercompany mergers and acquisitions have blurred distinctions among banks, commercial banks, securities dealers, insurance companies and insurance agencies. Harmonization on an international level through a single regulatory structure is hardly possible into the foreseeable future.

Given the nature of legal scholarship, it is reasonable to expect theories to arise around,

³²³ Both securities activities and insurance have been found “closely related to banking” under the Bank Holding Company Act, 12 U.S.C. §1840 *et seq*, and certain aspects of (brokerage activities, for example) and insurance (credit insurance) have been acknowledged to be part of banking.

³²⁴ P.L. 106-02, 113 Stat. 1338 (1999)

³²⁵ For an instance of national banks in the securities business see *Securities Industry v. Comptroller of the Currency*, 577 F. Supp. 252, *affd.* 758 F.2d 739 (D.C.Cir 1984); for national banks in the insurance business, see 12 U.S.C. §92.

explain and predict the process of international bank regulation. One such theory is called “regime theory.” We will do little more than name it.³²⁶ It applies mainly to international groupings based upon the agreement of sovereign states. Another theory, based upon lesser groups, more like the central banks that comprise CBS, is called “neofunctional theory.” It was devised in response to the proliferation of alphabet agencies that comprised the New Deal.³²⁷ BIS and CBS have generally avoided the abstruse theoretical constructs that attempt to explain their creation and predict their future. We believe that the work of these organizations can best proceed without such explanations. The way has been set. New problems will stimulate additional solutions. A theoretical superstructure will more likely impede than advance creativity. In this way the future of international bank regulation will be a self-creating operation.

We recommend that we both observe and participate in the process of international bank regulation. Internationalization is in evolution. It is moving from a past condition where there essentially was no international uniformity to some time in the future when, we may reasonably predict, there will be uniform international bank regulation. Meanwhile, the soft law issuing out of Basle has moved us a long way. We may see as an example of the process of evolution the gradual acceptance of the Basle Capital Accords. In 1987, a little more than a year before the Accords were issued by CBS, the United States and the U.K. entered into an agreement to

³²⁶ “As articulated by one of its foremost proponents, Robert O. Keohane, regime theory explains the prevalence of regimes as a function of the rational choice of their members, who enter them to constrain their choices and reduce the transaction costs of cooperation in an otherwise anarchic international society.” Keohane, “International Institutions and State Power, Essays in International Relations Theory,” (1989), 103.

³²⁷ Brierly, “The Covenant and the Charter,” (1947), 26. Part of neofunctional theory is that the development of some international agencies will stimulate the growth of others, an evolution called the “spillover effect.” Zaring, *supra*, note 6 at 315. We find this point of view not inconsistent with our own position.

implement common risk-based capital standards for banks in their respective countries.³²⁸ A year later, after CBS adoption of the Basle Accords in their first version, the full Group of Ten countries adopted the standards.

This is the process of evolution which has gone from no law at all³²⁹ to soft law. It should naturally proceed to hard law and a single law of international bank regulation. It need not be given mandatory direction; it need not be subjected to theory. There will continue to be new needs. They will be given new solutions. International bank regulation will in this manner continue to approach, finally to reach, the goal of a single mandatory supervisory structure.

CHAPTER VIII

Conclusion

The pace of countries' exposure to world financial and commodity markets needs to be carefully managed. It is the time for the development of international laws and regulatory institutions to cope with globalization.

The role of an international financial institution is to fuel the expansion of business globally, and to ensure confidence and liquidity in the markets. According to its own course of activity since its inception, the BIS has established itself as a credible, independent, and efficient

³²⁸ Duncan, *Basle Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry*. 10 Dick.Int'l L.Rev. 189, 195 (1992).

³²⁹ Three of the major international regulatory organizations in the financial area, dealing with banking, securities and insurance "were created informally," Zaring, *supra*, note ... at 301, and have evolved to highly structured, albeit soft law, institutions.

financial institution. We have seen the bank grow gradually, fulfilling its mission, when called to step in. These are the fundamentals on which the bank stands tall today, while gradually expanding its activities.

Expansion of the bank's activities will come by increasing its authority. In the normal course, a course already set, it will naturally increase its role in coordinating and setting standards for the activities of central banks. One can see it acquiring certain powers of intervention. The BIS' goal should be to reconcile and integrate different legal and policy frameworks. In the process, it should simplify existing procedures. However, it will need to offer very clear benefits to existing financial institutions, since increasing the BIS' authority will require major restructuring, investment and certainly, political endorsement. Its role will need to be clearly defined to avoid overlap with other institutions and to indicate precisely how its power will be exercised.

The BIS should be both allowed and encouraged to evolve towards a WFA. It should not now be transformed into a WFA. A two-tier system of supervisory responsibilities has taken over the supervision of international financial institutions. National authorities rule at the local level; supranational institutions are finding their places globally. A division of competence between national and supranational supervisory entities will be honed and pruned until the supranational authority will be a formal, law-making body. BIS seems the appropriate institution for this role.

Many prominent bankers, including former U.S. Secretary of Treasury, Robert E. Rubin, have made speeches³³⁰ calling for steps to strengthen the international financial architecture. Unfortunately, this choice of words conjures up visions of an architect's blueprint and a floor-to-ceiling renovation, when this is not in fact how the international financial system evolves. It evolves incrementally, changing marginally in response to pressures from markets and governments, not discontinuously in response to radical visions. The existing system is made up of a dense network of social, economic and financial institutions. As with any network, its components are lent inertia by their interaction and evolve incrementally in response to technological and other stimuli. So it is with the international financial system. History supports this interpretation, and the associated prediction.

It is anybody's guess to predict how far the BIS will go. It is clear, however, that the Bank is heading towards new challenges. As result, its role in the international financial architecture will be closely watched by bankers, regulators, politicians and the public. At the end, the last word in deciding whether the Bank becomes a WFA will belong to the financial markets' need for a supranational financial supervisor and, assuming the existence of such need, the ability of the countries of the world to cede a measure of their sovereignty to BIS.

³³⁰ Speech before the House Committee on Banking and Financial Institutions, Dept. of the Treasury (Press Room). May 20, 1999.