2-1-2004

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Carl Felsenfeld  
*Fordham, cfelsenfeld@law.fordham.edu*

Genci Bilali  
*Pinci & Associates, PLLC, New York, NY*

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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 sensitived 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
      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. 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.

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

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.” 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. 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


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


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 banks. 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. 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

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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

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


\(^10\) 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.\textsuperscript{11}

\textbf{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.”\textsuperscript{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:

\begin{center}
\textsuperscript{11} All of these events are mentioned in 61 Fed,Res.Bul. 606 (1975).
\textsuperscript{12} BIS web; bis.org/forum/index.htm.
\end{center}
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.\textsuperscript{13}

A marked change occurred in 1988 with the issue by CBS of the Basle Accord on Capital Adequacy.\textsuperscript{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.\textsuperscript{15}

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


\textsuperscript{14} See infra Chapter 3.

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 Times\textsuperscript{16} 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.\textsuperscript{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

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\textsuperscript{16} July 9, 1991.

\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{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.

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

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


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.
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.\textsuperscript{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, 1936\textsuperscript{28} and the Headquarters Agreement (entered between the BIS and the Swiss government on February 10, 1987\textsuperscript{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.\textsuperscript{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.

\textsuperscript{27} See Article 1 of the Hague Convention of 1930.

\textsuperscript{28} See The Brussels Protocol of July 30, 1936, at http://www.bis.org/about/protoc.pdf.


\textsuperscript{30} See Baker, \textit{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

\(^{31}\) \textit{Id}, at page 10.


\(^{33}\) 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{34} See id.

\textsuperscript{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

\textsuperscript{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.

\textsuperscript{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 naïve 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.\textsuperscript{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.”\textsuperscript{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

\textsuperscript{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.

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 BIS\(^\text{40}\) 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.\(^\text{41}\)

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.\textsuperscript{42}

No American official served as a director or alternate director of the BIS until 1994.\textsuperscript{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.\textsuperscript{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


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

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.”

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-

focus on global issues, and develop its role as a forum for collaboration between central banks in
the monetary and regulatory fields.\textsuperscript{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 Univers,\textsuperscript{47} with an annex above the
adjacent Frey's Chocolate Shop.\textsuperscript{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,

\textsuperscript{46} See The Times of November 10, 1993.

\textsuperscript{47} The building which was formerly the Grand Hotel et Savoy Hotel Univers 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.

\textsuperscript{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.


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.  

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. 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

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51 See id.
52 See Glyn Davis"A History of Money" (University of Wales '94)
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.”

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. It remains the duty of historians to uncover the historical truth of this dark period in the activity of the Bank.


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.

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. 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.”

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”.

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


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.  

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.


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. 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. 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. According to the BIS’

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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 duties 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;

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.
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 a 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.

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.

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. 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 a 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 securities.

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

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.  

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.  

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).

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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.  

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” 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 Meeting of member central banks;

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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;\textsuperscript{74} and,

- the Management\textsuperscript{75} of the Bank.

In the year 2003, the Bank counted 50 “shareholders” (central banks or financial monetary authorities\textsuperscript{76}) as members,\textsuperscript{77} exercising the rights of representation and voting at General Meetings\textsuperscript{78} 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.\textsuperscript{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

\textsuperscript{74} See Chapter IV of the BIS’ Statutes of January 20, 1930.

\textsuperscript{75} See id.

\textsuperscript{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 appointement 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.

\textsuperscript{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.

\textsuperscript{78} See below about “General Meeting”.

\textsuperscript{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.  

The Board of Directors of the Bank is composed of the governors 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.  

The statutes also provide 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. 

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, who can also be the Chairman or a member of the Board of Directors, General Manager or a Deputy General Manager. Heads of a department, or other officer or staff of the Bank. The staff of the Bank, including temporary staff, in the year 2003 numbered over 500 employees from over 40 countries. The President of the Bank implements policies approved by the Board as well as supervises administration of the Bank’s activities. 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.

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

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See id.

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

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


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

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

The Markets Committee was established in 1962.

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

The Basle Committee on Banking Supervision was established in 1974.
and the Committee on Payment and Settlement Systems. These committees participate in 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. 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. 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.

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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. 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.

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

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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

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 n 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.  

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.”

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


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:


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. The Herstatt failure contributed to a period of instability in international banking markets in the early 1970s and a general recognition that bank regulators in different countries had much the same problems. The CBS thus had as its original goal the strengthening of collaboration among national

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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. \textsuperscript{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. \textsuperscript{110}

As BIS says of the CBS in its website presentation, \textsuperscript{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


\textsuperscript{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.

\textsuperscript{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/bcbsc004.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.\footnote{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.}

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 1988\footnote{30 I.L.M. 980 (1988).} 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.\footnote{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.} The Accord reflects the effort of CBS to ensure a maximum degree of consistency between the framework agreed upon in Basle and the separate
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.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{124}

\textsuperscript{122} B.1 in the Amendment.

\textsuperscript{123} B.5 in the Amendment.

\textsuperscript{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


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.

CBS “intended the Core Principles to be applied in all countries.”\textsuperscript{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.”\textsuperscript{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.\textsuperscript{131} CBS anticipates incorporating the principles of the paper into the Core Principles in due course.\textsuperscript{132}

d. The Three Papers of September 1998.\textsuperscript{133} In September 1998, CBS issued three papers dealing with bank regulation:

\textsuperscript{129} Id.

\textsuperscript{130} Core Principles Methodology (October 1999) available on the BIS Internet website.

\textsuperscript{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.

\textsuperscript{132} Banking & Financial Services, August 2003, p.14.

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.”

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.”

\[134\] 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, 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.

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.” 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.”

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

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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.


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.\textsuperscript{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,\textsuperscript{141} a statute that brought banking, securities operations and insurance closer to one another.\textsuperscript{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.

\textsuperscript{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.


\textsuperscript{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.\textsuperscript{143} The Joint Forum identified itself in the report as representing the Committee on Banking Supervision, IOSCO, IAIS, thirteen countries\textsuperscript{144} 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 1998\textsuperscript{145} 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, CGFS\textsuperscript{146} 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

\textsuperscript{143} Available as Publication No. 47 on the BIS website.

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

\textsuperscript{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

\textsuperscript{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.\textsuperscript{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

\textsuperscript{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.\textsuperscript{149}

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

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

\textsuperscript{149} Salda, International Monetary Fund (1992), Lecture No. 131.

\textsuperscript{150} See Chapter III, subdivision 2.

course, nuclear energy.\textsuperscript{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,\textsuperscript{153} international payment systems, establishment of a

\textsuperscript{152} See text \textit{supra} at note 320.

\textsuperscript{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.


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


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.”

Today, there are over 120 countries, which have adopted the revised 1988 Basle Capital Accord.

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
http://www.bankofengland.co.uk/speeches/speech177.pdf.
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. 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 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).


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,


¹⁷² Those in charge of assigning ratings and approving loans should be independent of the marketing department and revenue producers.
internal review of such ratings\textsuperscript{173}, and overall transparency.\textsuperscript{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.\textsuperscript{175} As result, banks are creating data “warehouses,”\textsuperscript{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.\textsuperscript{177}

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\textsuperscript{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.

\textsuperscript{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.


\textsuperscript{176} See supra [speech by Mr. Rutledge, March 13, 2003].

\textsuperscript{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 York.
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), a majority of these banks were expanding their disclosure of lending information. 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. The most common individual disclosure items concerned the structure of capital, capital adequacy, and market risk.

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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.

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. 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,

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consequently influencing the overall risk profile of banking.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

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

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

\textsuperscript{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. 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.

These statistics show clear differences between the capital and lending decisions of banks and the effects of those decisions in different countries. Studies indicate that banks with relatively low capital ratios have tended subsequently to improve these ratios - in the process outperforming the better capitalized banks. 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,

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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


\(^{191}\) 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.\textsuperscript{192} According to a BCS study,\textsuperscript{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.\textsuperscript{194,195}


\textsuperscript{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.

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

\textsuperscript{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. 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.

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 regulations.

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Among banks and related financial institutions, there is a significant difference 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 encourage 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.\textsuperscript{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.\textsuperscript{199} Public disclosure of information about financial institutions varies widely throughout the world; not infrequently, such disclosure practices are minimal at


\textsuperscript{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.\textsuperscript{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

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. 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.

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

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International Lending Supervision Act. 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. U.S. bank regulators work systematically with banks in order to supervise their implementation of the Basle’s minimum capital requirements. 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. Banks 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%.

See 12 USC 3901 et seq.

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 expensive than purchasing securities, which in turn provided an incentive for banks to shift their portfolios away from loans and into securities.

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 ...”

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

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.


212 Id.

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 public.215

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.

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. Standards set by CBS are finding their way into the bank examination process. 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.

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 institutions.
conglomerates and holding companies. 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.” 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. Among the most relevant EU directives with respect to the EU’s compliance with the BIS’ recommendation are: the EU Directive on Investment Services; the EU Directive on Capital Adequacy; the EU Directive on Solvency Ratio; the EU Directive on Own Funds; and the EU Directive on

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223 See 93/22/EEC.

224 See 93/6/EEC.

225 See 89/647/EEC.

226 See 89/299/EC.
Deposit Guarantee Scheme.\textsuperscript{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.\textsuperscript{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.\textsuperscript{229}

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

\begin{itemize}
\item See 94/19/EC.\textsuperscript{227}
\item See speech by David Clementi, Deputy Governor of the Bank of England, at a Financial Services Authority Conference, held in London, December 2, 1999.\textsuperscript{229}
\end{itemize}
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. 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;

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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.\textsuperscript{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.\textsuperscript{232}

Within the EU, the supervisory authority on banking and securities is shared among the national financial supervisory authorities, European Central Bank\textsuperscript{233} and other international institutions, such as the BIS. This overlapping power, among supervisory institutions, potentially represents a conflict of interest.\textsuperscript{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

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\textsuperscript{231} BIS ECONOMIC PAPERS No. 47 \textit{in} 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).
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\textsuperscript{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).
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\textsuperscript{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.
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\textsuperscript{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.
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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


Most important is the need to strengthen Japanese banks’ capital base as it applies to credit, market, and operational activities. 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%.

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. Japanese banks 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.” 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

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outstanding loans which resulted in a sudden chain of bankruptcies among the affected firms.\textsuperscript{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.\textsuperscript{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


\textsuperscript{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. 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.

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

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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).

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.\textsuperscript{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.\textsuperscript{249} The BIS will continue to monitor the activities of banks and other financial institutions closely

CHAPTER V

Need for International Bank Guidelines

\textsuperscript{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.

\textsuperscript{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. 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

\[\text{\textsuperscript{250}}\] 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.
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. 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. 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.

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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
Committee intend to implement in their respective countries.\textsuperscript{255}

A commentator at the time wrote: “The July 1988 Report clearly envisions some form of subsequent adaptation by national authorities.”\textsuperscript{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?\textsuperscript{257}

\textbf{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.

\textsuperscript{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).\textsuperscript{256}

\textsuperscript{256} Norton, \textit{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, \textit{Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond}, 148 Pa.L.R. 1771 (2000), n.80\textsuperscript{257}

\textsuperscript{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, \textit{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. 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

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 Authority. 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.


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.

organization of an international lender-of-last-resort function by the IMF\textsuperscript{264} or the BIS.\textsuperscript{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.”\textsuperscript{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.”\textsuperscript{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


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

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.


269 See Eatwell and Taylor, supra, note .
which are already provided by the BIS. 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. 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. 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. 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


271 See infra, note 62.


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. 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.

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.

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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.  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.  

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.

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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. Making international financial institutions accountable to the WFA would introduce a “safety valve” consisting of evaluation and accountability.

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


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. 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. More countries have voluntarily agreed to BIS standards in order to achieve market credibility.


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


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.  

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.

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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

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. 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.

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.

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

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not caused by the countries’ policy mistakes and not requiring changes in policy.\textsuperscript{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.\textsuperscript{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.

\textsuperscript{291} See Stephany Griffith-Jones, “A New Financial Architecture For Reducing Risks and
Severity of Crises,” Friedrich Ebert Stiftung, Politik und Gesellschaft Online, International

\textsuperscript{292} IMF. 1998, \textit{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


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 favor 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.  

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.  

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.

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 notice.

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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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{298} See Forrest Capie, “Can there be an international lender-of-last resort?,” \textit{International Finance} 1:2, 1998, pp. 311-325.

\textsuperscript{299} See Anna Schwartz, “Time to terminate the ESF and the IMF,” \textit{Cato Institute, Foreign Policy Briefing}, No. 48, August 1998.

both comprehensive and fundamentally international and necessitate a strategy fostering international stability.\footnote{See Kiichi Miyazawa, “Towards a New International Financial Architecture,” Speech at the Foreign Correspondents Club of Japan, December 15, 1998.} 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.\footnote{See Stephany Griffith-Jones, “Global Capital Flows, Should They Be Regulated?,” London, MacMillan, 1998.}

Internal governance and market discipline should be at the heart of financial
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.\footnote{See William R. White, “What Have We Learnt From Recent Financial Crises And Policy Responses?,” BIS Working Papers, No. 84, January 2000.} 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.\footnote{See David Pearce, “Making Globalization a Positive Force for Sustainable Development,” Commonwealth Consultative Group on Environment, February 12, 2002.} 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
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.”

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 1999 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

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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.  

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.  

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.  

Eatwell and Taylor’s message is cogent:

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308 See Farhad F. Ghannadian, The Coming World Financial 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.”

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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.  

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 a 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. 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 crisis 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.”

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.

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 CBS, 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.” 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.


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. 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 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.

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


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. 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, the institution given that power also has a voice with CBS. 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.


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.\footnote{\textit{Nationsbank of North Carolina v. Variable Annuity Life Insurance Co. (Valic)}, 513 U.S. 251 (1995).} 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.
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.\textsuperscript{323} The Gramm-Leach Bliley Act of 1999\textsuperscript{324} 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.\textsuperscript{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,

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

\textsuperscript{324} P.L. 106-02, 113 Stat. 1338 (1999)

explain and predict the process of international bank regulation. One such theory is called “regime theory.” We will do little more than name it.\textsuperscript{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.\textsuperscript{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

\textsuperscript{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.

\textsuperscript{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, \textit{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. 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 all 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 regulator.


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 speeches\textsuperscript{330} 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.

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