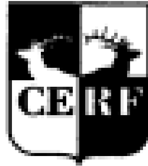

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Kern Alexander

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THE BASEL COMMITTEE AND GLOBAL GOVERNANCE

The deregulation and liberalization of domestic financial markets, combined with advances in technology, has resulted in a substantial increase in cross-border trade in financial services and portfolio capital flows. The changing structure of global financial markets has not only created more opportunities for profits but also has introduced a higher level of risk in financial transactions that may impact systemic stability. (Crockett, 2000) In the post-Bretton Woods era, banks and financial institutions have adopted innovative financial instruments to diversify earnings and to hedge against credit and market risk. This has led to increased international banking activity and to the rise of multi-functional universal banks. These developments have led to more efficient allocation of savings and investment and thus produced beneficial results for many economies, but have also made financial institutions more interdependent and thus subject to more volatile international capital flows. Recent financial crises in the 1990s suggest that these factors have destabilized financial systems, thus undermining national economic growth and social stability. These are the forces of financial globalisation that lend urgency to efforts to strengthen the architecture of the international financial system. This book addresses these issues from an interdisciplinary perspective that assesses the international economic, legal, and political issues for establishing an efficient, effective and legitimate global governance structure for financial markets. Governance is a multi-faceted term that takes on a variety of meanings across disciplines, and we apply it in the context of inter-state relations whereby policy-makers are confronted with the challenge of improving the regulation of systemic risk in global financial markets. Global governance of financial systems entails national regulators and supervisory authorities acting through international bodies and organisations to devise more effective and efficient standards of prudential regulation and to coordinate the implementation and enforcement of such standards in national jurisdictions.

Public and private sector bodies have been actively involved in developing international agreements to govern the business of international banking and finance. These agreements range from private cooperative arrangements by private sector entities to informal agreements negotiated by leading financial regulators of advanced economies, all the way to international treaties between sovereign states with detailed procedures for dispute resolution and enforcement. These agreements are viewed as

regulatory responses to the post-Bretton Woods dismantling of quantitative restrictions on domestic financial markets and international capital flows. These agreements can be divided into three categories: (1) Agreements to facilitate cross-border business conduct, i.e., standardized contracts (ISDA Master Agreement),[1] (2) Agreements to promote cross-border competition in banking and financial services, i.e., WTO's General Agreement on Trade in Services and OECD's Codes of Liberalisation. (3) Agreements to enhance and maintain financial stability through the efficient management of systemic risk. These agreements form the essential components of the existing international structure of financial regulation. This paper analyses the role of the Basel Committee on Banking Supervision and argues that its flawed institutional structure and standard setting process has failed to produce adequate international banking norms to regulate the business of global banking. Although the Basel Committee may have once played an important and appropriate role in setting international standards for the G10, its present structure and decision-making process needs to be reformed to take account of its global scope and increasingly obligatory nature. The standard-setting process of the Basel Committee (and other IFIs) has been criticised for producing inefficient standards of banking regulation due in part to its flawed institutional structure that lacks accountability and political legitimacy. Indeed, the concept of global governance has been used as a model for reforming international financial standard setting. Global governance requires that international standard setting be effective, accountable and legitimate. These core elements are not discrete and therefore must interact to produce an international decision-making process that derives its effectiveness in part from its accountability and legitimacy.

This paper offers some suggestions for reforming the institutional structure of international financial regulation that is premised on the notion that a more accountable and legitimate decision-making process will lead to more efficient standards of international regulation. This will involve devising a framework that ensures that international rules are adopted and implemented within a framework of global governance that is legitimate in a political sense and accountable over those whom it regulates. The paper's conclusions are preliminary and subject to further research into how principles of global governance can be applied to international standard setting in financial markets.

I. THE CONCEPT OF GLOBAL GOVERNANCE

Most experts understand governance as the establishment and operation of a set of rules of conduct that define practices, assign roles, and guide interaction in order to address collective problems. (Young 2000) The international political system is composed primarily of nation states, which act as the principal agents in creating and operating international governance systems. International relations scholars also refer to international governance systems as regimes, which are commonly defined as 'norms, rules, and procedures agreed to in order to regulate an issue area.' (Haas 1980) According to international governance or regime theory, states jealousy guard their sovereignty against other states, and seek to promote their perceived national interests by adopting measures to enhance the security of their citizens. International

[1] These also include codes of conduct for best practices in the sale of financial products, technical standards that allow the electronic exchange of messages (SWIFT) for interbank funds transfers, and netting and custodial services.

governance systems (or regimes) usually involve states sharing a common view of certain rules of conduct, which are often formalized, and sometimes enforced by states or collectives of states.

This approach has traditionally studied the concept of governance through the lens of state actors by focusing on the creation and operation of rules in inter-state relations. In contrast, the term *global governance* covers not only those phenomena but also situations where the creators and operators of rules are non-state actors, working across state boundaries and at different levels of the international system. One view asserts that a myriad of global governance systems can be found at various levels, and that there is a trend in international affairs in which authority has been reallocated away from direct state-to-state relations to arenas where supranational, transnational, and subnational actors all play a role in setting internationals standards and rules that govern state and private actor behaviour (Rosenau 1995).[2] This concept of global governance contrasts with the narrower view of *international governance* implied in regime analysis, which focuses primarily on inter-state relations. Global governance is more broadly conceived, referring to the creation and operation of rules at other levels involving transnational and subnational actors, while still recognising the important role that states play in the international system.

Global governance of financial systems involves the interaction of state policies and regulations that apply to financial institutions and markets, and how state policymakers interact with regulators and private sector bodies through international bodies and organisations to develop standards and rules to enhance financial stability and to improve competition in the financial services industry. This paper will focus on international efforts to regulate systemic risk in financial markets. It argues that the efficient regulation of systemic risk in global financial markets requires international institutional structures of supervision that can set forth and oversee the implementation of effective rules and standards of regulation. Moreover, these principles of international financial regulation must be accountable to those subject to their application and legitimate in the sense of taking account of different national economic structures that may necessitate different modes of implementation in different jurisdictions.

II. THE END OF BRETTON WOODS AND SYSTEMIC RISK

The elimination of the Bretton Woods fixed-exchange rate parity with gold resulted in the privatisation of foreign exchange risk, which created the need for banks to adopt hedging strategies involving the diversification of assets into multiple currencies and portfolios held in foreign and offshore jurisdictions. This created pressure on national regulatory authorities to eliminate controls on cross-border capital movements, which led to the further deregulation of financial markets. The resulting increase in cross-border capital flows made it necessary for national regulatory authorities to promote safe and sound banking systems that involved the effective management of systemic risk. The G10 industrial countries took the lead by adopting international minimum standards of prudential supervision intended to reduce systemic risk and to provide conditions of competitive equality for financial institutions operating in different jurisdictions. The privatisation of foreign exchange

[2] This view seems to revitalize the well-known themes of globalism and interdependence literature of the 1960s and 1970s.

risk occurred because the Bretton Woods par value fixed exchange rate system was dismantled. This shifted forex risk onto the private sector, which in turn put pressure on governments to liberalise their national controls on cross-border capital flows so that financial institutions could spread their risks to foreign assets and transactions. This led to a significant increase in short term cross-border portfolio investment that has, in many instances, exposed capital-importing countries to increased systemic risk due to the volatility of cross-border capital flows.

The first major banking collapse that resulted from the privatisation of financial risk and which focused the attention of the international financial community on the need for enhanced international banking supervision occurred in 1974 and involved major banks from Great Britain, West Germany and the United States. In June 1974, West German authorities closed the Herstatt Bankhaus (Herstatt) following losses from foreign exchange dealings that threatened severe disruption of the US clearance system (Dale, 1984), while UK authorities closed the British-Israel Bank of London for insolvency problems (Kapstein 1989). The closure of Herstatt and British-Israel Bank of London exposed major weaknesses in the international banking system (Peake, 1986). Shortly thereafter, the Franklin National Bank in the United States collapsed under the combined weight of bad management in the volatile domestic wholesale deposit base, excessive speculation in international foreign exchange markets, and over ambitious efforts to expand (Dale, 1992). To prevent the crisis from spreading, the US Federal Reserve intervened by guaranteeing the bank's failed short-term foreign exchange commitments. It has been argued that these banking collapses occurred because of the lack of adequate regulatory standards to protect against financial risk (Eatwell & Taylor 2000).

During the 1980s and 1990s, a market-led global financial system emerged in which the volume of financial assets, the sophistication of international financial transactions, and advances in computer and telecommunications technology increased dramatically. By contrast, no corresponding institutional framework nor regulatory response has been developed on the international level to provide effective and efficient regulation of globalised financial markets. Unlike the Bretton Woods era, the current international financial order has led to recurring financial crises and overall declines in rates of economic growth and investment in the OECD countries. (Ibid) In response, governments have attempted to recover some of the regulatory controls that they had exercised during the Bretton Woods era. For example, leading developed states have established various international bodies to improve the supervision of financial institutions involved in banking, securities, and insurance. These bodies have agreed on various sets of principles and rules establishing what are now agreed to be generally accepted international standards of prudential supervision. Notwithstanding these efforts, recent financial and currency crises in the 1990s demonstrate the inadequacies of the current international regime of financial regulation. This led the leading industrial states to create in 1999 the Financial Stability Forum, which meets twice a year to examine potential threats to the international financial system.[3]

The current loosely assembled regulatory and institutional framework for supervising international financial markets has been criticised for lacking coherence

[3] See www.fsforum.org

and political legitimacy (Woods 2000). Other argue that more concerted efforts at the international level are needed to manage systemic risk (Eatwell & Taylor 1999). Indeed, the British Chancellor of the Exchequer Gordon Brown recognised the need for more concerted efforts at international regulation of financial markets when he stated '[B]ecause today's financial markets are global, we need not only proper national supervision, but also a fundamental reform – global financial regulation.' (Brown, 1999) Accordingly, the leading industrial states have responded to these events by proposing a set of policy initiatives designed to increase the efficiency, stability and transparency of international financial markets.(Group of Ten 1996 & Group of 22 1998)) Although these proposals for a new international financial architecture remain vague and subject to much dispute, there is a growing consensus that a coherent institutional framework must be established to administer and facilitate the implementation of international standards.'

THE PROBLEM OF SYSTEMIC RISK

Systemic risk arises because of the mispricing of risk in financial markets, which often means that risk is underpriced in relation to its cost, and that the underpricing of risk results in too much of it being created in financial markets. Often, those private actors who create financial risk do not internalise its full cost, thus leading to excessive risk that may take the form of substantial exposures accumulated by banks and derivative-dealing houses in foreign exchange markets and in speculating in financial instruments whose values depend on variations in interest rates in different markets. Overexposures to risk may precipitate a financial crisis that may result in bank runs and/or a collapsed currency. These are the excessive costs of risk that can be shifted onto society at large as a negative externality, in much the same way as the cost of pollution (in terms of health and environmental damage) is shifted onto society at large as a result of the underpricing of certain modes of production that create pollution.

Systemic risk may take the form of credit risk, market risk, settlement risk, liquidity risk or operational risk. Credit risk has been defined as 'the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.' (Basel 2000a) Market risk, in contrast to credit risk, relates to the fluctuations of the market, whether in relation to movements in the interest rate, equity prices or other traded instruments. Settlement risk applies to all forms of derivatives but, owing to the relative size of the foreign exchange market, it is most prevalent amongst foreign exchange market participants. (Basel 2000b) The Basel Committee has acknowledged two types of liquidity risk: (1) market liquidity risk, and (2) funding liquidity risk.(Basel 2001a). Market liquidity risk concerns a party's ability to liquidate a position. This will depend on a number of factors including the market for the product, the size of the position and possibly the creditworthiness of the party's counterparty. Funding liquidity risk is a different issue that focuses on the ability to fund a position. Operational risks is a residual category known as *other risks* that covers a broad area including (but not limited to) fraud, legal negligence, misconduct, or technology failure. In part II of the book, we will address how these categories of risk create systemic risk.

The lack of a coherent international regime to provide standards for the risk-taking activities of financial institutions has exposed financial systems to an increased risk of systemic failure. Indeed, increasing linkages amongst the world's financial

markets have led to a significant expansion in the number, size, and types of activities, and in the organizational complexity of multinational financial institutions. Although these cross-border linkages generally bring efficiency to world capital markets, the increasing scope of international banking activity has highlighted the difficulty of ensuring effective supervision and may, in some cases, increase systemic risk, whereby losses in one banking group can affect the entire financial system. (GAO 1994) The systemic risk inherent in international banking include: (1) global systemic risk – the risk that the world's entire banking system may collapse in response to one significant bank failure; (2) safety and solvency risks that arise from imprudent lending and trading activity; and (3) risks to depositors through the lack of adequate bank insurance.(Cranston, 1996) Moreover, financial fraud activities also pose a significant threat to an internationalised banking industry. In these situations, systemic risk becomes a negative externality that imposes costs on society at large because financial firms fail to price into their speculative activities the costs associated with their risky behaviour.(Eatwell & Taylor)

Although the taking of risks is a large part of what financial institutions do, prices in financial markets reflect only the private calculation of risk, and so tend to under-price the risk – or the cost – of investments faced by society at large. This under-pricing of risks in financial markets creates a negative externality caused by excessive risk-taking that may result in a financial crisis. The regulator's task is to internalise the negative externality of risk, ensuring that investors take into account the risks their activities impose on society. This may be accomplished through either of two approaches: (1) by requiring firms to internalise the costs of the risks they take by, for example, requiring them to adhere to capital adequacy standards or certain risk management practices, or (2) by the direct regulation of a firm's activities. In this way, the financial regulator seeks to require businesses to behave as if they took systemic risk into account, which thereby should reduce the occurrence of systemic breakdown in financial markets. Although effective regulation can make a significant contribution in reducing normal systemic risk, it can never protect firms and markets from abnormal market risk. Even the best regulatory standards and risk management practices may sometimes be overwhelmed by exceptional market turbulence. However, by building confidence in the maintenance of market stability in normal times, it will likely reduce the chance of abnormal market risk.

In addition, banks have increasingly recognised that traditional methods of risk management have become obsolete and that new measures are needed to assess the risk of new financial instruments. The objective of reducing risk in complex financial markets has led banks to use innovative financial instruments to diversify earnings among several countries so that, in any given year, an inadequate *investment* outcome in one country may be offset by a positive investment outcome in another country. This need to reduce risk by expanding cross-border financial services has also resulted in the establishment of complex organisations, known as financial conglomerates.[4] An international financial conglomerate is an integrated group of companies, which offers a broad range of financial services. While financial conglomerates offer the benefits of diversified assets, risks, and sources of earnings, their structure poses several problems for regulators. Comprehensive supervision of financial conglomerates requires that supervisors develop standards that address the degree of

[4] The term 'financial conglomerates' includes at least one financial component in an industrial or commercial operation. See G. Adams, 'The Regulation of Financial Conglomerates', *Jrnl. Of Financial Crime*, Vol 5, no. 3 pp. 215-217.

transparency[5] within the organization and the placement of overall supervisory responsibility with a particular regulator. Moreover, the interrelationship of various divisions within a multinational conglomerate increases the likelihood that the default or liquidation of an affiliate in one jurisdiction will 'spill-over' to other affiliates or controlled entities in other jurisdictions.[6] To prevent systemic risk from occurring on the international level, national regulatory authorities should coordinate their efforts to produce effective international standards of financial supervision to ensure that financial conglomerates internalise their costs of operation.[7]

As banking becomes more international and deregulated, national regulatory authorities remain the prime supervisors monitoring cross-border banking activities. But expanded and diversified international banking operations require adherence to a common core of supervisory and regulatory standards recognised by the world's major financial regulators. These core international standards require effective international supervision to reduce systemic risk. The effective control of systemic risk requires a global supervisory regime that performs certain essential functions, including, *inter alia,* the generation of norms and rules of prudential supervision, surveillance of financial institutions and markets, and coordinating enforcement by national authorities of international regulatory standards.

III. THE BASEL COMMITTEE ON BANKING REGULATION AND SUPERVISORY PRACTICES ('THE BASEL COMMITTEE')

The Basel Committee was established in 1974 by the Group of Ten (G10)[8] in response to the Herstatt bank crisis and other banking failures that occurred in the aftermath of the Bretton Woods collapse. It consisted of representatives from banking supervisors and central banks of the G10 plus Switzerland and it met on the premises of the Bank for International Settlements ('BIS'). The Basel Committee did not rely on a formal written instrument as the basis for its mandate, but rather issued a press communique that was announced by the BIS on February 12, 1975.9 The Basel Committee communique states that its "key objectives" are to "strengthen international cooperation, improve the overall quality of banking supervision worldwide, and ensure that no foreign banking establishment escapes supervision." (Lovett 1993 458). To accomplish this, the Committee has developed principles of "consolidated supervision" over the past decade and created a multinational framework for bank capital adequacy requirements, among other regulatory efforts. The Basel Committee has arguably become the most successful ongoing effort at

[5] Transparency requires full disclosure of information about the entire operations of a multinational financial conglomerate, including financial groups of the conglomerate, parent companies, and its subsidiaries. See Freis, p. 11 (assessing increased transparency of German financial markets, improved investor's rights, and regulating participation in stock exchanges and securities markets).

[6] The risk of contagion occurs where losses in one activity reduce the capital available to support other parts of the corporate group or where visible difficulties in one affect confidence in other areas of the same group. See Scott (1987) p. 35.

[7]This may require firewall provisions to protect both consumers and taxpayers against possible conflicts of interest and to prevent the spread of a national safety net (deposit insurance) provided to banks, and any associated subsidy, from spreading, to non-banking activities.

[8] In 1974, the G10 consisted of Belgium, Canada, France, Italy, Japan, Luxembourg, The Netherlands, West Germany, United Kingdom, and the United States.

[9]The Basel Committee has promulgated no formal constitution or bylaws and has few staff or facilities; it uses the facilities of the Bank for International Settlements and has no legal personality in international relations. (Norton 1995, pp. 176-77 n. 18).

international financial diplomacy in history.

1975 BASEL CONCORDAT

The first meeting of the Basel Committee was in December, 1974 when the central bank governors of the G10 countries began negotiations over international supervisory cooperation in response to major bank failures in 1974 and the increased threat that foreign exchange risk posed to banking systems. The G10 representatives agreed on a Concordat that established guidelines for banks operating outside their home states. The Concordat focused on the respective roles of the home and host state supervisors and regulatory authorities to ensure adequate financial supervision (Basel 1975). Specifically, it established five basic principles delineating the supervisory responsibilities of home and host countries' banking regulators in overseeing banking institutions that operate on a transnational basis. The Concordat emphasized that all banks operating in host countries should be supervised by both the home country's and the host country's supervisory authorities.[10] It recommended that the host authority take primary responsibility for the adequacy of the foreign bank's liquidity. The home country's supervisory authority should, in turn, be primarily responsible for the solvency of a home country's bank whilst that bank is operating in a foreign country.[11] The fifth principle emphasises the need for cooperation between home and host country regulatory authorities in removing all legal restraints on the transfer of confidential financial information if such information is considered necessary for effective supervision (Cooke 1987).

1983 REVISED CONCORDAT

In 1983, the Basel Committee members adopted new principles that further refined the 1975 Concordat with a view to ensuring that consolidated supervision could occur on a transnational basis. These principles were contained in the Principles for the Supervision of Banks' Foreign Establishments (Revised Concordat 1983).[12] The Revised Concordat established new principles for the allocation of bank regulatory responsibilities between home and host authorities. The Revised Concordat focused on ensuring that no bank operating in a foreign country could escape adequate supervision, and, hence, developed the approaches of 'consolidated supervision' and 'dual key' supervision.[13] Consolidated supervision means monitoring the risk exposure (including the concentrations of risk, the quality of assets, and the capital adequacy) of the banking groups for which the home authority bears responsibility, on the basis of totality of the business, wherever conducted. Consolidated supervision expands the responsibilities of the home country's regulatory authority by requiring the home country regulator to monitor the total risk exposure and capital adequacy of the home country's bank. The home country regulator is able to do so by reviewing the bank's total transnational operations.[14]

In contrast, 'dual key supervision' means that the regulatory authority of each nation concurrently assesses the ability of other national authorities to supervise and carry out their respective responsibilities. Where a host country determines that a

[10] Ibid.
[11] Ibid.
[12] The Basel Committee acted in response to the financial crisis that arose from the Latin American sovereign debt crisis and from the financial scandal involving Banco Ambrosiano.
[13]Ibid., 905.
[14]Ibid., 904.

home country has inadequate supervision, the Revised Concordat proposes two options: (1) the host country could deny entry approval to an institution from a country which does not adequately supervise its own institutions (Revised Concordat),[15] or (2) it could impose specific conditions governing the conduct of the business of foreign banks seeking to operate in the host jurisdiction.[16] When a host country does not have adequate supervision, the Revised Concordat urges the home country's regulatory authorities to discourage the home country's bank from expanding its operations into the proposed host country.[17] The purpose behind the dual-key approach was to prevent countries from lowering supervisory practices in order to attract foreign investment and foreign capital (Alford 1992).

THE RESPONSE TO BCCI: MINIMUM INTERNATIONAL STANDARDS

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

- all international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision;
- the creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's, or banking group's, home country supervisor;
- supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor;
- if a host-country authority determines that any one of the foregoing minimum standards has not been met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of a banking establishment.(Basel 1992)

The Minimum Standards not only emphasize the need for consolidated supervision but also recommend that the host country regulators ensure that the home country receives consolidated financial statements of the bank's global operations. The Minimum Standards further exhort that the home country's regulators have the means to satisfy themselves as to the completeness and validity of all financial

[15] According to the Revised Concordat, the primary purpose of the Basel Committee is to examine the totality of each bank's worldwide business on the basis of consolidated supervision. .
[16]Ibid.
[17]Ibid.

reports. In addition, the host country's regulators should assure themselves that the home country's regulators have the authority to prevent banks under their jurisdiction from establishing organizational structures that circumvent supervision.

SUPERVISORY STRUCTURES FOR FINANCIAL CONGLOMERATES

The growth of financial conglomerates[18] has increasingly eroded the distinction between banking and other financial services. Banks are no longer the major institutions in the process of intermediation. In the past decade, non-bank financial institutions, including securities firms, financial companies, and insurance companies, have joined the intermediation process in most major financial markets (Litan & Rauch 1997).[19] International financial conglomerates today are providing an array of products and services, including not only the traditional offerings of loans and deposits, but also *inter alia* insurance, investment options, and tax and estate planning. These modern financial institutions conduct diversified operations across borders to diversify their earnings and enhance profits. The liberalisation of restrictions on capital flows across national borders has increased international lending and deposit-taking activities. Increasing integration of financial markets benefits international capital flows and facilitates economic development.[20]

In 1996, the Basel Committee, International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) created the Joint Forum on Financial Conglomerates[21] to devise standards for the effective regulation of financial conglomerates that operate in different jurisdictions and in different financial services sectors. The Joint Forum has issued a number of proposals seeking to improve coordination between regulators. Specifically, it has proposed that a lead regulator be appointed for each conglomerate that would be determined based on the conglomerate's overall activities. In mixed conglomerates with financial and other activities, it is proposed that the financial divisions of the group have separate legal personality. In February 1999, the Forum issued a final paper proposing measurement techniques and principles for assessing the capital adequacy of financial conglomerates on a group-wide basis (Joint Forum 1999).

BASEL CAPITAL ACCORDS

The other key component of the Basel Supervisory Framework is the concept of capital adequacy for financial institutions. The rationale for capital adequacy standards is that banks should set aside a capital charge to offset the bank's risk-based exposure, and that this reduce would reduce systemic risk and contagion that could occur because of disorderly capital flows arising from a bank failure. In the aftermath of the Latin American sovereign debt crisis of the early 1980s, US and UK authorities were the first to adopt capital adequacy standards for banks with international

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[18] We adopt the term 'financial conglomerates' to describe multifunctional financial firms that often serve as holding companies for subsidiaries and affiliates that provide a wide range of financial service activities. (Blumberg, 1993 6-10).

[19]Litan and Rauch argue that non-banks' invasion of banking has prompted banks to seek the freedom to enter other areas of financial services, such as insurance and securities. (1997 26) This has occurred in the US market where the entry of non-banking institutions into the banking business has forced banks to expand business activities into non-traditional banking areas in order to remain competitive.

[20]In 1996, net international capital flows to developing countries exceeded $235 billion; this amounted to 0.8 percent of world GDP, and more than two percent of developing country GDP. (Fischer 1997).

[21]The Joint Forum has a mandate to continue the work begun by the Tripartite Group on the harmonisation of standards for financial conglomerates.

operations. In 1983, Congress enacted the International Lending Supervision Act of 1983, which was the first US statute to impose capital adequacy standards on US banks. In the UK, a major reorganisation of the financial services regulatory framework in 1986 resulted in statutory requirements for capital adequacy of banks in the Banking Act 1987. This recognition of the importance of capital adequacy standards led to the UK-US Bilateral Capital Accord of 1987. Aware of the potential for regulatory arbitrage by banks operating in other G10 countries with less exacting capital adequacy requirements, the UK and US initiated negotiations in the Basel Committee that resulted a 1988 Capital Accord. The 1988 Capital Accord was entitled 'International Convergence of Capital Measurement and Capital Standards' and it applied based on the principle of home country control to banks based in G10 countries with international operations (Basel 1988).

The two major points supporting an international capital accord was that banking regulators wanted to adopt an international minimum standard that would create a level playing field for banks operating in the G10 countries and that banking regulators wanted capital requirements to reflect accurately the true risks facing banks in a deregulated and internationally-competitive market. The 1988 Capital Accord required banks actively engaged in international transactions to hold capital equal to at least 8 per cent of their risk weighted assets. This capital adequacy standard was intended to prevent banks from increasing their exposure to credit risk by imprudently incurring greater leverage. The Capital Accords advocated two principal goals: (1) to require banks to maintain higher levels of capital reserves by maintaining capital-to-asset ratios that are 'risked-based' (i.e. that reflect the real credit risks as well as the risks of banks' off-balance sheet portfolios); and (2) to establish a level-playing field so that a bank based in one country would not receive a competitive advantage by enjoying a lower capital adequacy requirement than a bank based in another country (Scott and Iwahara). Although these guidelines are not legally binding, the G-10 countries have incorporated them into their national banking regulations; and a number of non-G-10 countries have voluntarily implemented these standards into their national banking laws.[22]

INTERNAL RISK MANAGEMENT MODELS

In the early 1990s, national supervisors began to complain that the credit risk component of the Capital Accord was too narrow to deal with market, liquidity, and operational risks, all of which increased with the growth of banks' trading and derivative books. On 12 April 1995, the Basel Committee developed a new approach to the calculation of capital requirements (Basel 1995).[23] The approach allows banks, for the first time, to use their internal risk-management models to determine regulatory capital requirements. Instead of adhering to a detailed framework for computing risk exposures (for reporting purposes) and capital requirements, banks are able, under certain conditions, to use their own models—the ones they use for day-to-day trading and risk management—to determine an important component of their regulatory capital requirements. In particular, the Basel Committee advocates value-at-risk as the standard measure for risk exposures. Value-at-risk is an estimate of the maximum loss in the value of a portfolio or financial system over a given time period

[22] Australia, Austria, Finland, Hong Kong, Israel, Korea, Mexico and Taiwan have adopted laws incorporating the Basel standards, and so have some emerging market economies. (Follak 2001) p. 307.
[23] This defines a series of quantitative and qualitative standards that banks would have to meet in order to use their own system for measuring market risk.

with a certain level of confidence. This level of confidence is represented by the probability that the actual value of a particular capital account will not decline beneath a specified minimum value over a period of time at a given probability. Value-at-risk also refers to the requirement of closer involvement with the banks under supervisory control and formal risk assessments using appropriate evaluation factors. The Basel Committee adopted the value-at-risk model in 1997 and it has been implemented into law by the G-10 national regulators. Banks are encouraged to participate in the design framework for determining risk weightings for particular asset classes (Folkerts-Landau & Takatoshi 1995).

Decision-making and Basel 2

The internal operations and deliberations of the Basel Committee are not disclosed to the public (GAO 1994). The Basel Committee works informally and operates by consensus. Its operations are distinguished by an emphasis on personal contacts, insistence on the nonbinding nature of the agreements it concludes, and an interactive and decentralized method of ensuring compliance. The Committee operates through a rotating chair and makes recommendations based on consensus. The Committee has declared that the development of close personal contacts between supervisors in different countries has greatly helped in addressing and resolving problems that may undermine the safety and soundness of financial systems. The Committee has sought to extend its informal network with banking regulators outside the G10 through the Core Principles Liaison Group. Most recently, it has conducted seminars and consultations with banking regulators from over 100 countries as part of the prelude to adopting the Basel 2 agreement.

The Committee publishes its proposed standards and rules in draft form for public comment. These reports range from generally worded documents to technical, mathematical regulations used to provide guidance for the implementation of the promulgations. After a comment period, the Committee reconsiders and then reissues a final version of its work, which the central bankers are then strongly encouraged to implement into domestic law. For example, the 1988 Capital Accord exemplified the Basel Committee's informal procedure and illustrated the Committee's expansive understanding of consensus (Kapstein 1994). The Accord set universal minimum capitalization standards for international banks regulated by the members. The impetus for the Accord was the 1987 bilateral capital adequacy agreement between the United Kingdom and United States.[24] This agreement formed the basis for the draft proposal of the 1988 Accord that emphasised ‘international convergence of supervisory regulations governing the capital adequacy of international banks (Capital Accord 1988). There was a six-month comment period, during which it received comments on its draft agreement from a variety of private bankers and other interested parties. The Committee revised the Accord and released a final version on July 15, 1988. The Committee members then implemented the standards in their home jurisdictions. Since its promulgation, the Committee has regularly amended the Accord. The Committee characterises its capital framework as "not static, but . . . intended to evolve over time."[25]

The Committee’s informal standard-setting process attempts to reach a convergence of international principles of banking supervision that relies upon

[24]The US and UK governments called the agreement ‘Convergence of Capital Adequacy’. (Kapstein 1994 114-15.)
[25]Annexure C, at ¶ 5.

national implementation of internationally agreed standards to ensure that, over time and under the pressure of market forces, national regulators adhere to similar principles and approaches for regulating the banking sector (Lichenstein 1991). Consequently, monitoring noncompliance is a decentralized task that is the responsibility of member states themselves, and not international organisations, such as the BIS, or other international bodies. Nonetheless, the Committee monitors and reviews the Basel framework with a view to achieving greater uniformity in its implementation and extension of its principles to a wider group of countries. In the case of the Capital Accord, the Federal Reserve notes that the Basel Committee reviews questions relating to implementation of the framework by all countries with internationally-active banks. (Board of Governors 1991). Although all G10 countries have professed adherence to the Capital Accord during the 1990s, credit rating agencies have determined that some countries, such as Japan, have failed to adhere to minimum standards of capital adequacy because of financial market distress. The Committee, however, has apparently considered experimenting with other means of ensuring compliance with its standards, including establishing a clearinghouse for world-wide supervisory practices and creating a formal peer review process to assess compliance (GAO 1994).

In June 1999, the Basel Committee proposed significant reforms to the 1988 Capital Accord that would place greater reliance by regulators on private credit rating agencies and internal bank ratings (Basel 1999). These proposals specifically addressed the inadequacy of the 1988 Accord's efforts to assess credit risk in light of rapidly changing conditions in financial markets. The 1999 proposed reforms to the Capital Accord recommended replacing the existing system of credit weightings by one which would use private agencies' credit assessments to determine risk weights. The proposed reforms also contained suggestions for allowing some sophisticated multinational banks to use their own internal ratings of loans as a basis for calculating capital adequacy ratios.

The Basel Committee adopted further revisions After commentary from the banking sector and government regulators, the Basel Committee released a further revision of the proposed reforms to the Capital Accord on January 16, 2001 (known as the new Capital Accord). These proposed amendments modify and substantially expand the 1999 proposals by specifically describing the methods by which banks can determine their minimum regulatory capital requirements.26 The structure of the new Accord contains three mutually reinforcing pillars that comprise the framework for assessing capital adequacy. The first pillar is the minimum regulatory capital charge that includes both the standardised approach (adopted in the 1988 Accord with subsequent amendments) and a revised internal ratings based approach. The revised standardised approach provides enhanced, though limited, sensitivity to various risk categories. The internal ratings based approach represents a fundamental shift in the Committee's view on regulatory capital by placing greater emphasis on the internal credit risk rating practices of banks. This allows sophisticated institutions to estimate the amount of capital they believe necessary to support their economic risks.

[26] Although most national authorities had not applied the 1988 Accord to banks that did not have foreign establishments, US regulators had applied the 1988 Accord to all banks, irrespective of whether or not they operated in foreign jurisdictions.

The second pillar is supervisory review, "intended to ensure that not only banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy. Subject to the discretion of national regulators, it provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. The third pillar recognises that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. The Committee therefore is proposing a wide range of disclosure initiatives designed to add more transparency to the risk and capital positions of a bank. The Committee intends to finalise the new Accord by December 31, 2003, and national governments will be encouraged to adopt the necessary legislation to implement the standards beginning in 2004 with a final deadline for the end of 2006.

The Basel Committee's integral role in establishing global banking norms is demonstrated by its work on the 1988 Capital Accord, the revised Capital Accord (Basel 2), the Concordats, anti-financial crime measures, and standards regulating financial conglomerates. However, short-comings in the decision-making process of the Basel Committee have recently been recognised as a possible cause of poor standard setting, especially in the Basel 2 exercise. The weaknesses of Basel 2 are possibly a result of a standard setting process that fails to adequate involve regulators from non-G10 countries. Many experts (Ward 2002 & Griffiths & Persaud 2003) have criticised Basel 2 for being pro-cyclical, too complex, and distorting trade between large and small banks. Expanding the number of countries involved in the Basel 2 standard setting process would lead to more efficient and effective standards that would likely attain a higher degree of accountability and legitimacy.