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CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION: AN ENFORCEABLE INTERNATIONAL FINANCIAL STANDARD?

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Abstract: The Basel Committee on Banking Supervision serves as an international forum to discuss international bank supervision issues. Because of the gravity and frequency of banking crises since the demise of the Bretton Woods System in the early 1970s, international financial standards have emerged as a method to minimize these crises. In 1998, the Basel Committee issued a comprehensive standard on bank supervision that built upon its work over the previous two and a half decades. In this Article, the author analyzes this comprehensive standard—the Core Principles for Effective Banking Supervision—and assesses its implementation in the European Union, the United Kingdom, France, the United States, and the Hong Kong SAR. The author then analyzes the options available to enforce this “soft law” and comments on the effectiveness of these options, including the surveillance programs of the World Bank and the International Monetary Fund and certain provisions of the Revised Capital Accord of 2004. Despite the improvements represented by the Core Principles, the author suggests future changes in the international bank supervisory regime.

INTRODUCTION

Banking is typically one of the most regulated industries within a nation’s economy because it serves as the economy’s payment mechanism, gathering financial assets and redeploying them for productive purposes through loans and other types of credit.1 Because banking and its payment function are so crucial to an economy’s operation, national governments tend to regulate this industry heavily and occasion-

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ally even own banks. As international trade has grown, each nation’s banking system has likewise become more international. World merchandise trade increased from US$ 579 billion in 1973 to US$ 6,272 billion in 2002. International bank loans increased from US$ 2,713.7 billion in 1985 to US$ 20,212.9 billion in 2003—a 744% increase.

Despite this growth in international banking, national governments have been very hesitant to enter into international agreements that involve ceding regulatory control of banks incorporated or operating within their jurisdictions. National governments tend to view any transfer of regulatory control over their banking systems as akin to a surrender of sovereign power.

National governments generally wish to retain control over banking systems because of the high costs and negative political repercussions of bank failures. National governments, and related agencies such as a central banks, typically have lender of last resort responsibility for banks operating within their borders. If a bank has insufficient liquid funds to meet payment demands from depositors, the national government, through its central bank, may lend funds to the bank to meet these demands. Furthermore, if a bank becomes insolvent, the national government can provide funds to the depositors of the failed bank through a deposit insurance program, allowing depositors to recoup losses caused by the insolvency (or a significant portion thereof).

Several articles have documented the costs of resolving banking crises as a percentage of the national Gross Domestic Product. For example, the cost of an early 1990s banking crisis in Finland amounted to 11% of

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5 See Dale, supra note 2, at 187.
6 Dobson & Hufbauer, supra note 2, at 101–02.
7 Id.
8 Id.
9 Id. at 102, 106.
Likewise, a financial crisis in Mexico from 1994 to 1995 cost 20% of that country’s GDP, and a crisis in Thailand in the late 1990s cost 42% of its GDP. If a systemic financial crisis results from such bank failures, the associated economic costs can increase exponentially. Furthermore, a major disruption in the financial system generally leads to a change in government.

Since the early 1970s national governments have agreed to international financial standards that set guidelines for best practice in regulating banks and, in particular, internationally active banks. These standards, however, are not legally enforceable. They are merely soft law, voluntary guidelines on regulatory and supervisory practices over the banking industry. The most prominent institution issuing these standards for the banking industry has been the Basel Committee on Banking Supervision (“Basel Committee” or “Committee”).

This Article analyzes one of these international financial standards—the Core Principles for Effective Banking Supervision (“Core Principles”) and in particular the mechanisms available to enforce this soft law. The first Section describes the Basel Committee’s history and structure. It analyzes the Basel Committee’s earlier pronouncements on bank supervisory practices, particularly those regarding the coordination of international bank supervision. The second Section analyzes the implementation of the Core Principles in the national laws of five important financial markets: the European Union, the United Kingdom, France, Hong Kong, and the United States. The third Section discusses the options for enforcement of the Core Principles, including key provisions of the recently issued Revised Capital Accord (or Basel II) that effectively buttress the Core Principles. The

12 Id.
final Section forecasts future development in the Core Principles. The formulation of such developments is an “iterative process.”16

I. DEVELOPMENT OF CORE PRINCIPLES

After World War II, the Allied nations created several international institutions to manage the international financial system (“Bretton Woods”).17 One of the key attributes of the Bretton Woods system was fixed foreign exchange rates.18 This managed system allowed for financial stability, but also created economic inefficiencies. In the early 1970s, as the result of several factors, this system of managed foreign currency rates disintegrated.19 Floating currency rates, at least for the industrialized nations, replaced fixed exchange rates and allowed for greater efficiencies and greater growth in both international trade and international finance.20 Nevertheless, this new, less stable, and more volatile international financial system was plagued by many more bank crises than were experienced under the Bretton Woods system.21

As in other nations, U.S. regulation of foreign banks traditionally focused on the operations of foreign banks within U.S. borders.22 Yet, as financial markets globalized, events in other nations had the potential to cause dramatic, and sometimes devastating, effects on local economies. With the globalization of the banking industry, the systemic risk of a financial crisis has increased, but banking regulation among nations has not developed congruently to meet this greater risk.23 The Basel Committee, by issuing a series of guidelines for bank supervision, attempts to rectify this situation.24 The Basel Committee’s

18 The New Palgrave Dictionary of Money and Finance, supra note 17, at 235.
20 Walker, supra note 13, at 23.
21 See Hoggard et al., supra note 11, at 9.
23 See Dale, supra note 2, at 167–68.
24 See Walker, supra note 13, at 135–36.
efforts to harmonize bank regulation have, thus far, culminated with the issuance of the Core Principles in September 1997.

A. Brief History of the Basel Committee

The 1974 collapse of the Herstatt Bank in Germany and the 1975 failure of Franklin National Bank in the United States led to the creation of the Basel Committee and the issuance of the Concordat, the Committee’s first agreement on bank supervision. The Herstatt Bank failed due to its fraudulent bookkeeping practices, and other German banks were unable to rescue it. Although legal claims against the Herstatt Bank were eventually settled, and although mainly domestic assets were involved, the resolution of the bank’s failure—particularly the incomplete satisfaction of foreign creditors’ claims—set a negative precedent for the settlement of international financial crises and demonstrated the need for greater regulatory cooperation with respect to international banks.

The Franklin National Bank (“Franklin”) failure demonstrated how the abandonment of the Bretton Woods system left banks more exposed to currency rate risk. Franklin, at the time the twentieth largest bank in the United States, closed in 1974. Although weak management and a large amount of non-performing loans contributed to the bank’s failure, Franklin’s collapse occurred largely because


27 Hess, supra note 26, at 186. West German banks received 45%, foreign banks received 55%, and other creditors received 65% of their respective claims. Id.

28 Id.

29 Walker, supra note 13, at 25.

30 Id. at 26–27.
of foreign exchange trading losses that prompted institutional depositors to withdraw their funds.\textsuperscript{31}

The Basel Committee was organized in 1975 in direct response to the Herstatt Bank and Franklin failures.\textsuperscript{32} The Committee’s members consist of banking regulators from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.\textsuperscript{33} The Basel Committee secretariat is located at the offices of the Bank for International Settlements in Basel, Switzerland.\textsuperscript{34} Although some observers have criticized the Committee for its lack of members from emerging markets,\textsuperscript{35} its pronouncements have regularly included consultations with regulators from emerging markets and transition economies.\textsuperscript{36}

The purpose of the Basel Committee is to provide “regular cooperation between its member countries on banking supervisory matters.”\textsuperscript{37} The Committee seeks to harmonize the banking laws of various nations indirectly through the issuance of guidelines developed by consensus among its members.\textsuperscript{38} The discussions held by the Basel Committee are confidential, and the Committee does not publish

\textsuperscript{31}Id. at 27–28.


\textsuperscript{34}Bank for Int’l. Settlements, 74th Annual Report 157 (2004). Two deputy directors are permanent staff at the Bank for International Settlements. The remaining professional staff of the Basel Committee are on loan from member nations. See The Basel Committee on Banking Supervision, at http://www.bis.org/bcbs/aboutbcbs.htm (last visited Apr. 12, 2005).


\textsuperscript{36}Core Principles, \textit{supra} note 15, at 1–2. The Basel Committee was very influential in the creation of regional bank supervisory groups such as the Offshore Group of Banking Supervisors. These groups serve as forums for the Basel Committee to communicate efficiently with its peers in emerging markets. See, e.g., Fin. Action Task Force on Money Laundering, Offshore Group of Banking Supervisors, at http://www1.oecd.org/fatf/City-ogpgpages/org-ogbs_en.htm (last visited Apr. 12, 2005).

\textsuperscript{37}Peter Cooke, The Basle “Concordat” on Supervision of Banks’ Foreign Establishments, 39 Aussenwirtschaft 151, 151 (1984).

\textsuperscript{38}See id.
minutes. The Committee does, however, publish its findings, and recent standards have involved much more consultation with non-member regulatory authorities, as well as the financial services industry and the general public. While the Committee has no legal enforcement power itself, it encourages member nations to abide by these regulatory guidelines and to use whatever authority they possess to enact and enforce them. Typically, the Basel Committee standards are endorsed at the biennial meeting of the International Conference of Banking Supervisors. The Committee has issued several guidelines on international banking supervision: the Concordat of 1975 (“Concordat”); the Revised Concordat; the Capital Adequacy Standards (“Basel I”), the Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments (“Minimum Standards”); and, most

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39 Bank for Int’l Settlements, supra note 13. The Basel Committee used to keep minutes of its meetings. Currently, the Committee keeps a detailed action plan as the only written record of its meetings. These documents are for internal use only and are not available to the public. See Carl Felsenfeld & Genci Bilali, The Role of the Bank for International Settlements in Shaping the World Financial System, 25 U. Pa. J. Int’l Econ. L. 945, 964 (2004).


43 Concordat, supra note 25.


47 Core Principles, supra note 15.
recently, the International Convergence of Capital Measurement and Capital Standards: A Revised Framework ("Revised Capital Accord" or "Basel II"). Appendix A contains a brief timeline of the Basel Committee’s principal standards. The Core Principles and their enforceability are the main focus of this Article.

B. The Concordat of 1975

As a result of the Herstatt Bank failure and the subsequent confusion over the settlement of the bank’s liabilities, the Committee sought to establish an agreement on the respective roles of home country supervisors to ensure supervision over all international financial institutions. The Committee attempted to fulfill this task by issuing the Concordat, which delineated the supervisory responsibilities of home and host country regulators over international banks. By entitling the document a “concordat,” the Committee indicated that the agreement was not a binding treaty, but instead a set of guidelines on bank supervision, adopted by consensus among Basel Committee members.

The objectives of the Concordat were to ensure the adequate regulation of foreign banks and the prevention of foreign banks from escaping supervision. A central tenet of the Concordat was joint responsibility between home and host countries in regulating international banks.

50 The home or parent regulator is responsible for supervision in the country where the “parent bank” is headquartered and licensed. See Concordat, supra note 25, at 30. The host regulator is responsible for supervision in the foreign country where the “parent bank” is operating an establishment. See id.
52 See id. The word “concordat” refers to a “public act of agreement” (as opposed to a “contract” between private parties). Id.
53 Concordat, supra note 25, at 29–30; see Cane & Barclay, supra note 33, at 321.
54 Dale, supra note 32, at 12. The Concordat set forth five principles:
   (1) The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities.
   (2) No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities.
The Concordat dealt primarily with the liquidity, solvency, and foreign exchange operations of foreign banks. The host supervisory authority was responsible for regulating liquidity, regardless of the type of banking entity established in the host nation. The Concordat allocated responsibility for solvency between host and home regulators depending on the type of foreign banking establishment involved; subsidiaries and joint ventures were the responsibility of the host regulator, while branches were the responsibility of the home regulator.

The Concordat had several weaknesses. First, despite its attempts to allocate supervisory responsibility, it still left unclear which regulator should act to contain a major bank failure. Also, designation of the host supervisor as the primary solvency regulator of foreign bank subsidiaries ran contrary to the system of consolidated supervision used in most industrialized nations. The allocations of responsibility in the Concordat presented a risk that host regulators, following consolidated

(3) The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations.

(4) The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks’ moral commitment in this regard.

(5) Practical cooperation would be facilitated by transfers of information between host and parent authorities and by the granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of cooperation.


55 See Concordat, supra note 25, at 29.

56 See id. at 30. Liquidity is a measure of a bank’s ability to convert assets to cash or cash-equivalents without diminution of the assets’ value. Jerry M. Rosenberg, *Dictionary of Banking & Financial services* 415 (1985).

57 Concordat, supra note 25, at 30–31. Solvency is a measure of a bank’s ability to generate cash flow sufficient to satisfy its liabilities as they mature and to provide an adequate return to its shareholders. Black’s Law Dictionary 1428 (8th ed. 2004).


59 Dale, supra note 32, at 173. Under consolidated supervision, responsibility for regulating a bank’s foreign subsidiaries is shared between host and parent regulators, with the parent supervisor considering all of the assets and liabilities of the bank, wherever located, in order to determine the bank’s overall solvency. See id. at 176.
supervision, would look to parent supervisors to regulate a bank subsidiary’s solvency, while parent regulators, relying upon language in the Concordat, would look to the host supervisor to perform this task.\textsuperscript{60}

Finally, the Concordat lacked specific supervisory standards for Committee members to employ,\textsuperscript{61} allowing individual nations to interpret the Concordat in inconsistent manners.\textsuperscript{62} The most important and potentially dangerous interpretation involved the mistaken belief that lender of last resort responsibility accompanied supervisory responsibility.\textsuperscript{63} The Committee never intended the Concordat to deal with lender of last resort responsibility.\textsuperscript{64}

The 1982 financial collapse of the Luxembourg subsidiary of Banco Ambrosiano, the largest Italian bank at the time, highlighted the weaknesses of the Concordat. The Luxembourg subsidiary had made US$ 1.4 billion worth of imprudent loans to Latin American companies.\textsuperscript{65} Concurrently, the subsidiary owed nearly US$ 450 million to other creditors.\textsuperscript{66} Unable to pay its creditors, Banco Ambrosiano and its Luxembourg subsidiary collapsed.\textsuperscript{67}

\textsuperscript{60}Id. at 173. The “primary motivation” for drafting the Revised Concordat, adopted in 1983, was to “incorporate understandings on applying the principle of consolidated supervision to banks’ international business.” Cooke, supra note 37, at 152–53.

\textsuperscript{61}Dale, supra note 32, at 173.

\textsuperscript{62}In 1979, the Federal Reserve Board (“FRB”) proposed that U.S. offices of foreign banks report on the structure and condition of their parent banks to the FRB, but regulators in other nations thought this requirement would violate provisions of the Concordat. Id. The Federal Reserve eventually received power to enforce such a reporting requirement under the Foreign Bank Supervision Enhancement Act. Id. On another occasion, the FRB was faced with a three-way international disagreement as to the Concordat’s meaning. Id. Swiss regulators believed that host regulators had primary responsibility for regulating branches and subsidiaries of foreign banks. Id. In contrast, regulators in Great Britain believed that host regulators were responsible for supervising only foreign bank subsidiaries. Id. Bank regulators in the Netherlands, in yet another interpretation, believed that the parent regulator was responsible for the supervision of its subsidiaries. Id. at 173–74.

\textsuperscript{63}Id. at 174. “Lender of last resort responsibility” refers to the obligation of a central bank or regulator to provide as much liquidity as necessary to a bank in order to meet its obligations to depositors and creditors. Id.

\textsuperscript{64}See Cooke, supra note 37, at 153–54. The Concordat is silent on this point. See id.

\textsuperscript{65}See Hess, supra note 26, at 188–89, 191.

\textsuperscript{66}Id. at 190.

Neither the Luxembourg nor the Italian regulators claimed supervisory or lender of last resort responsibility for the bank.68 The Italian regulators argued that they lacked the legal authority to regulate the Luxembourg subsidiary and bore little or no responsibility for its failure.69 Italian regulators pointed to the way that their previous attempts to examine Banco Ambrosiano’s South American offices were rebuffed by local regulators as proof of their inability to regulate Banco Ambrosiano’s foreign subsidiaries. Italian regulators argued that they would not take responsibility for the failure of a bank they were not permitted to supervise properly.70 Luxembourg regulators, on the other hand, ignored Italian requests to tighten their supervision of the Banco Ambrosiano subsidiary, believing that a subsidiary operating under the same name as its parent bank (as was the case with the Luxembourg subsidiary of Banco Ambrosiano) should have been supported either by the parent bank or indirectly by the central bank in the parent bank’s home country.71 Thus, Luxembourg regulators believed that the Banco Ambrosiano parent bank or the Italian central bank should have supported the Luxembourg subsidiary.72

C. The Revised Concordat of 1983

The Committee responded to the collapse of Banco Ambrosiano by issuing the Revised Concordat in 1983.73 The Revised Concordat was not an entirely new agreement, rather it built upon the original Concordat.74 Like its predecessor, it was a non-binding agreement that embodied “recommended guidelines of best practices.”75 Under

69 Dale, supra note 32, at 175; Hess, supra note 26, at 192.
70 Hess, supra note 26, at 192–93.
71 See Dale, supra note 32, at 175; Dale, supra note 54, at 57. The turmoil resulting from Banco Ambrosiano’s failure ended when two settlement agreements were signed: the first between the liquidators of Banco Ambrosiano and the creditors of the Luxembourg holding company (and its foreign subsidiaries); and the second between the creditors of Banco Ambrosiano and the creditors of the Vatican bank. Hess, supra note 26, at 194–95. In the aftermath of the Banco Ambrosiano affair, the Italian Parliament passed a law that required disclosure of the shareholder structure of banks and also passed enabling legislation for the 1983 European Union Council Directive on Supervision. Id. at 199.
72 Hess, supra note 26, at 191.
73 Revised Concordat, supra note 44, at 901; see Dale, supra note 49, at 12.
74 See Hall, supra note 68, at 166; Cooke, supra note 37, at 152–53; see also Revised Concordat, supra note 44, at 901 (using the original Concordat as a foundation).
75 Revised Concordat, supra note 44, at 901.
the Revised Concordat, nations still retained authority to license banks with few restrictions—even banks they were unable to regulate effectively. Furthermore, it provided no incentive for compliance with its provisions other than the political pressure that bank regulators could exercise on their recalcitrant colleagues. Nevertheless, with the Revised Concordat, the Committee attempted to close the supervisory gaps that existed under the original Concordat and directly address the adequacy of foreign bank regulation.

1. “Dual Key” Supervision

As with the original Concordat, a primary objective of the Revised Concordat was to ensure that no foreign bank escaped supervision, and that each establishment was supervised adequately. The Revised Concordat introduced a “dual key” approach whereby both home and host supervisory authorities assessed the quality of the other’s supervision of an internationally active bank. The host jurisdiction had to be satisfied with the supervision over the parent bank within its home jurisdiction; likewise, the parent bank’s home jurisdiction had to be satisfied that the foreign operations of its domestic banks were supervised adequately by the host regulators.

If the host regulator considered the parent regulator’s supervision insufficient, the host regulator had the right to discourage or prohibit the foreign bank from operating within its jurisdiction or to set stringent conditions for the bank’s continued operation therein. Likewise, the parent regulator could attempt to extend its jurisdictional reach if it did not believe that the host regulator was providing adequate supervision. Alternatively, it could discourage or prohibit the parent bank from operating in the host nation. Using this “dual

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76 See Mendelsohn, supra note 51, at 2 (criticizing the Basel Committee for repeating its failure to address lender of last resort responsibility in the Revised Concordat).
77 See id. (noting that the Revised Concordat remained “no more than an informal agreement”).
78 Revised Concordat, supra note 44, at 903; see Dale, supra note 2, at 169.
79 See Dale, supra note 49, at 12.
80 Id.; see Revised Concordat, supra note 44, at 903–04. The “dual key” approach is highly dependent on effective communication and active cooperation among host and parent regulators. See Dale, supra note 49, at 12.
81 Revised Concordat, supra note 44, at 903–04; Dale, supra note 32, at 175. This provision was a concession to U.S. regulatory authorities, whose previous attempts to monitor the status of foreign parent banks with U.S. offices were met with strong resistance from foreign supervisory authorities. Id.
82 Revised Concordat, supra note 44, at 903; see Hess, supra note 26, at 200.
83 Revised Concordat, supra note 44, at 903; see Hess, supra note 26, at 200.
key” approach, the Committee intended to prevent a “race to the bottom”—the tendency for jurisdictions to relax financial regulation and supervision in order to attract more foreign investment.  

In the Banco Ambrosiano case, no regulator took responsibility for the supervision of the Luxembourg-based bank. If the Revised Concordat principles had been applied to the Banco Ambrosiano situation, Luxembourg would have had primary responsibility to supervise the subsidiary, but if the parent regulator (Italy) had not been satisfied with that supervision, it could have provided its own supervision. The “dual key” system in the Revised Concordat was designed to encourage nations to make their bank supervision practices equivalent to those present in the most stringently regulated financial centers. Such convergence, however, required bank regulators to prohibit weakly regulated banks from operating within their jurisdiction and to prevent their own adequately regulated banks from expanding into inadequately regulated jurisdictions. The first scenario would result in the loss of foreign investment, the second in forgone international business opportunities.

The Revised Concordat allocated supervisory responsibility between host and parent regulators based on both the nature of the regulatory objective (e.g., liquidity, solvency) and the type of banking establishment. The Revised Concordat describes three types of foreign banking establishments: branches, subsidiaries, and joint ventures or consortia.

The responsibility for foreign bank solvency depended on the type of bank establishment. The parent supervisor was responsible for regulating branch solvency because the branch was still legally a part

84 Dale, supra note 49, at 12.
85 Dale, supra note 32, at 175.
86 See Revised Concordat, supra note 44, at 903. The Revised Concordat calls for a concerned parent regulator to extend its supervision in such a manner “to the degree that it is practicable.” Id.
87 See id.
88 See id.
89 See Hall, supra note 68, at 166–68 (providing a succinct summary of the Revised Concordat).
90 Revised Concordat, supra note 44, at 902. A branch does not have a separate legal status from the parent bank. Id. A subsidiary is a legally independent entity that is wholly-owned or majority-owned by the parent bank. Id. Joint ventures or consortia are “legally independent institutions incorporated in the country where their principal operations are conducted and controlled by two or more parent institutions, most of which are usually foreign and not all of which are necessarily banks.” Id.; see Hal S. Scott, Supervision of International Banking: Post-BCCI, 8 GA. ST. U. L. REV. 487, 487–510 (1992).
of the parent bank.\textsuperscript{91} Parent and host supervisors had joint responsibility for subsidiaries.\textsuperscript{92} The host supervisor had some responsibility because the subsidiary was a legally independent institution; the parent supervisor had responsibility because of the principle of consolidated supervision (described below) and the effect of the subsidiary’s activities on the overall financial status of the parent bank.\textsuperscript{93} Supervision over the solvency of joint ventures was primarily the responsibility of the regulator in the joint venture’s country of incorporation.\textsuperscript{94}

Under the Revised Concordat, liquidity referred to the ability of a foreign bank to meet its obligations as they fell due; it did not refer to lender of last resort responsibilities.\textsuperscript{95} Host regulators were primarily responsible for supervising the liquidity of branches and subsidiaries.\textsuperscript{96} Parent regulators could also be concerned with liquidity, because branches may call upon the resources of the parent bank and the parent bank may issue comfort letters or other standby credit instruments to its subsidiaries.\textsuperscript{97} For joint ventures, the country of incorporation had primary responsibility over liquidity.\textsuperscript{98}

2. Consolidated Supervision

In addition to the concept of “dual key” supervision, the Revised Concordat adopted the principle of consolidated supervision. Under this principle, the parent supervisor monitored a parent bank’s risk exposure and capital adequacy based on all the operations of the bank, wherever conducted.\textsuperscript{99} The Basel Committee acknowledged that adoption of this concept might extend the traditional jurisdictional limits of a parent regulator’s supervisory responsibility.\textsuperscript{100}

In April 1990, the Basel Committee issued a paper discussing the exchange of information among bank supervisors as a supplement to

\begin{itemize}
  \item \textsuperscript{91} Revised Concordat, supra note 44, at 905
  \item \textsuperscript{92} Id. at 906.
  \item \textsuperscript{93} Id. This provision differs from the original 1975 Concordat, where supervision of a subsidiary’s solvency was primarily the responsibility of the host regulator. See Concordat, supra note 25, at 31–32.
  \item \textsuperscript{94} Revised Concordat, supra note 44, at 906–07.
  \item \textsuperscript{95} Id. at 906.
  \item \textsuperscript{96} Id. at 907.
  \item \textsuperscript{97} See id.
  \item \textsuperscript{98} Id.
  \item \textsuperscript{99} Revised Concordat, supra note 44, at 905; see Dale, supra note 32, at 176.
  \item \textsuperscript{100} Revised Concordat, supra note 44, at 905.
\end{itemize}
the Revised Concordat.\textsuperscript{101} In this paper, the Committee stressed its concern over the prohibition against sharing certain information with supervisors in certain countries.\textsuperscript{102} The Committee then set forth its view as to the best practice for sharing prudential information.\textsuperscript{103} The Committee stressed that information received under agreements between prudential supervisors was to be be used for supervisory purposes only, and that the confidentiality of the information provided must be assured.\textsuperscript{104} If the recipient authority wished to take action based on information received, it first should consult with the sending authority.\textsuperscript{105} The statement sought to outline arrangements that would allow for the greatest possible flow of relevant information among bank supervisors.\textsuperscript{106} Only through trust and shared information would bank supervisors be able to monitor international bank operations effectively.\textsuperscript{107}

3. Weaknesses of the Revised Concordat

Nevertheless, the Revised Concordat, like its predecessor, also contained some weaknesses. Its explicit refusal to address the issue of lender of last resort responsibility presented one major weakness.\textsuperscript{108} Theoretically, if banking regulators cooperate to prevent bank failures, they should also cooperate in upholding the international banking system when a failure is imminent.\textsuperscript{109} The Committee did not address lender of last resort responsibility because some members of the Committee were not central banks and thus lacked any lending power with which to support failing banks.\textsuperscript{110} More fundamentally, the Committee avoided the issue because the central banks of the industrialized nations had stated vaguely that they would support the li-

\textsuperscript{102} Id. at 2–3.
\textsuperscript{103} Id.
\textsuperscript{104} Id.
\textsuperscript{105} Id. at 5.
\textsuperscript{106} Exchange Document, supra note 101, at 2.
\textsuperscript{107} See id. at 3.
\textsuperscript{108} Revised Concordat, supra note 44, at 901 (stating that it does not address lender of last resort responsibility); see Mendelsohn, supra note 51, at 2.
\textsuperscript{109} David W. Wise, International Prudential Regulation of Commercial Banks, Bank Admin., June 1985, at 58, 62 (stating “[j]ust as laws should provide for their own enforcement, supervision should provide for the eventuality that such supervision can fail”).
\textsuperscript{110} Mendelsohn, supra note 51, at 2.
quidity of the international markets in times of crisis. In drafting
the Revised Concordat, the central bankers sought to leave this prior
commitment vague in order to encourage private sector discipline
and minimize moral hazard. The central bankers hoped to create a
delicate balance between creating confidence in financial markets
and discouraging reckless behavior by financial institutions.

The Revised Concordat purposely blurred host and parent regu-
latory responsibilities in order to avoid the type of finger-pointing
that occurred among regulators after the Banco Ambrosiano failure.
In doing so, however, it also created problems of overlapping authority
and responsibility in cases where one regulator was designated the
primary regulator, but another also had a strong interest in maintain-
ing effective supervision over a foreign bank. This overlap created
uncertainty for regulators with respect to their supervisory responsi-
bilities. In theory, the parent regulator should have ultimate re-
sponsibility for the safety and soundness of its banks in all of their
forms and establishments, foreign and domestic. The principle of
consolidated supervision allows a parent regulator, in the course of
enforcing its own regulations, to approve or disapprove of its banks’
foreign operation. Nevertheless, despite significant improvements
over the original Concordat, the Revised Concordat still left gaps in
the coordination of international bank regulations.

The difficulty of implementing consolidated supervision seemed
evident from the drafters’ treatment of international bank holding
companies. The Revised Concordat designated the host regulator
(rather than the parent regulator) as the primary supervisor of subsidi-
ary banks controlled by a bank holding company, but failed to desig-

111 See id. (noting statement of support of Euromarkets still applies).
112 Id. “Moral hazard” refers to the economic concept whereby an economic actor
will pursue risky behavior that it otherwise would not have because of an external subsidy. See
Hidden Actions, Moral Hazard and Contract Theory, 2 THE NEW PALGRAVE DICTIONARY OF
113 See Mendelsohn, supra note 51, at 2.
114 Wise, supra note 109, at 62.
115 Revised Concordat, supra note 44, at 906 (stating that the countries in which joint
ventures are incorporated (host countries) have primary responsibility for supervising the
joint venture, but that the parent regulators of banks that are shareholders in the joint
venture cannot ignore supervision of the joint venture).
116 Wise, supra note 109, at 62.
117 Id.
118 Revised Concordat, supra note 44, at 906.
119 See id. at 904.
nate a primary regulator of the bank holding company itself.\footnote{120} This omission would prove to be a very significant gap—one that the Bank of Commerce and Credit International ("BCCI") would later exploit.\footnote{121}

As banks expanded into new and different lines of business, they tended to develop complex holding company structures. These attenuated and far-flung corporate structures, such as the one maintained by Banco Ambrosiano, often allowed banks to escape effective regulation.\footnote{122} Under the Revised Concordat, a holding company with independent banks operating in different countries could avoid meaningful consolidated supervision because no one regulator had responsibility for the holding company’s overall financial strength.\footnote{123} Likewise, effective supervision of a holding company with both bank and non-bank subsidiaries required the cooperation of multiple regulators that differed not only by geography, but also by function (insurance, securities, banking).\footnote{124}

In the 1980s, BCCI likewise took advantage of a fragmented corporate structure in order to avoid comprehensive regulation.\footnote{125} In a coordinated action on July 5, 1991, regulators in eight nations closed all the BCCI branches located within their jurisdictions.\footnote{126} At the time, BCCI had total assets of approximately US$20 billion and was operating in sixty-nine countries, with the largest concentration of its deposits in the United Kingdom.\footnote{127} Due to the absence of any inter-

\footnote{120}{ See id.}
\footnote{121}{ See Dale, supra note 49, at 12 (pointing out that BCCI’s structure was such that it could avoid stringent consolidated supervision under the Revised Concordat).}
\footnote{122}{ Banco Ambrosiano consisted of a parent bank in Italy and several foreign subsidiaries, including banks located in Peru, Panama, and Luxembourg. See Hess, supra note 26, at 189–90. The Luxembourg subsidiary, Banco Ambrosiano Holding, itself had a Bahamian subsidiary, Banco Ambrosiano Overseas Ltd. See id. at 190.}
\footnote{123}{ Revised Concordat, supra note 44, at 904.}
\footnote{124}{ See id.}
\footnote{125}{ See David Lascelles, First Step Towards Tougher Regulation, FIN. TIMES (London), Sept. 2, 1991, at 13.}
\footnote{126}{ Max Hall, The BCCI Affair, BANKING WORLD, Sept. 1991, at 8. The eight nations were the Cayman Islands, France, Germany, Luxembourg, Spain, Switzerland, the United Kingdom, and the United States. Id. Indeed, on that day, action to shut down BCCI’s activities was taken in more than sixty nations. Id. See generally Duncan E. Alford, Basle Committee Minimum Standards: International Regulatory Response to the Failure of BCCI, 26 GEO. WASH. J. INT’L. L. & ECON. 241 (1992) (describing the failure of the international bank BCCI and the complex, coordinated action by bank regulators to minimize depositors’ losses).}
\footnote{127}{ Statement by J. Virgil Mattingly, Jr., General Counsel, Board of Governors of the Federal Reserve System, William Taylor, Staff Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and E. Gerald Corrigan, President, Federal Reserve Bank of New York, before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, Sept. 13, 1991, in 77 FED. RES.
national law governing international bank closures, local regulators acted under separate national laws. The closure of BCCI branches continued for several weeks and, by July 29, 1991, forty-four jurisdictions had closed BCCI offices located within their borders.

The immediate reason for the closure of BCCI was the massive fraud committed by BCCI’s senior managers. Through the mid-1980s, the treasury operations of BCCI suffered huge losses, and senior managers siphoned off deposits to cover them. If the depositors withdrew their money, then other deposits were diverted to cover the losses. This practice resulted in an endless series of fraudulent transactions. Senior managers, board members, and representatives of major shareholders participated in the fraud by making fictitious loans, failing to record deposits, and dealing in their own shares in order to manufacture profits. BCCI also used client names to trade on its own account. BCCI managers hid the losses caused by bad trades, unpaid loans, and fraudulent practices by shuttling assets between subsidiaries.

Bull. 902, 905 (1991) [hereinafter Mattingly Statement]. BCCI was no longer accepting retail deposits in its U.S. offices because of actions taken previously by U.S. bank regulators. Id. at 907.

Cf. Claire Makin, Learning from BCCI, INSTITUTIONAL INVESTOR, Nov. 1991, at 93, 94–95 (discussing various local investigations into BCCI and the lack of overall international accountability). In a 1989 interview, former BCCI chief executive Swaleh Naqvi acknowledged that “[b]ecause we do not have a dominant presence in any single country, the full impact of what we are doing is not visible.” Id. at 94.

Mattingly Statement, supra note 127, at 908.


Lascelles, supra note 131, at 32.

Hall, supra note 126, at 8. For example, BCCI reported loans of US$ 445 million to Ghaith Pharaon, a Saudi business executive, and US$ 796 million to the Gokal family in Pakistan; both borrowers were shareholders of First American Bankshares, which was secretly owned by BCCI. These loans were not secured with any assets, nor were they in fact made to the named individuals. See Jonathan Friedland, Rest in Pieces, FAR E. ECON. REV., Sept. 26, 1991, at 64, 66. See generally JAMES RING ADAMS & DOUGLAS FRANTZ, A FULL SERVICE BANK: HOW BCCI STOLE BILLIONS AROUND THE WORLD (1992) (chronicling the BCCI affair).

All Things to All Men, supra note 131, at 67.

The Many Facades of BCCI, ECONOMIST, July 13, 1991, at 81. In addition, Price Waterhouse discovered a secret “bank within a bank,” controlled by top BCCI officials, which hid losses and plugged holes in the balance sheets by raising deposits without re-
The BCCI affair was “a case of systematic and deliberate criminal fraud . . . [in which] BCCI took maximum advantage of an unsupervised cooperative [sic] structure to conceal and warehouse in bank secrecy jurisdictions billions of dollars in fraudulent transactions.”136 BCCI was able to take advantage of technological advances that allowed it to shift funds world-wide very quickly. The BCCI scandal illustrates that, as the banking industry becomes global, the potential for global fraud or mismanagement grows concurrently.

The circumstances surrounding the closure of BCCI called into question the “adequacy of international supervisory arrangements.”137 The Basel Committee began discussions of the ramifications of the BCCI closure almost immediately.138 In light of BCCI, the Committee members generally agreed that there was a need to strengthen the provisions of the Revised Concordat.139 To this end, in July 1992 the Committee issued the Minimum Standards.140

D. Minimum Standards

In the Minimum Standards, the Committee tightened its position on international bank supervision141 and strengthened the principles reflected in the Concordat and the Revised Concordat.142 The Minimum Standards stated that: (1) all international banks and banking groups should be supervised by home country regulators; (2) international banks should obtain permission from both the host and home country regulators before opening branches or other banking establishments in foreign nations; (3) banking regulators should have the right to gather information from international banks; (4) host regulators can impose restrictive measures against the international banks if the Minimum Standards are not met; and (5) encouragement of in-

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136 Mattingly Statement, supra note 127, at 905.
137 Hall, supra note 126, at 8.
138 The new Minimum Standards were issued in July 1992, only a year after BCCI was completely closed. See MINIMUM STANDARDS, supra note 46. The drafters somewhat cryptically noted that they began their work on the standards “[f]ollowing recent developments.” Id. at 1.
139 See id.
140 Id.
142 MINIMUM STANDARDS, supra note 46, at 1. The 1990 Supplement to the Revised Concordat concerning “Information Flows Between Banking Supervisory Authorities” was not made part of the Minimum Standards. See id. at 1–2.
formation exchanges between regulators in different nations should continue.\textsuperscript{143}

1. Consolidated Supervision Redux

The Minimum Standards stated that all international banks should be subject to consolidated supervision by their home country regulators.\textsuperscript{144} This required that the home country regulator receive reliable information on the global operations of the particular international bank.\textsuperscript{145} Supervisors then would assess this information in monitoring the safety and soundness of international banks.\textsuperscript{146} Under the Minimum Standards, home country bank regulators could prevent the creation of corporate affiliations that undermined the application of consolidated supervision or hindered effective regulation,\textsuperscript{147} and also could prevent the opening of banking establishments in foreign jurisdictions if they were not satisfied with the host country supervision.\textsuperscript{148}

Host country regulators likewise had the responsibility to ensure that the home country regulators had the ability to meet these standards.\textsuperscript{149} The Minimum Standards required that international banks receive permission from both home and host country regulators before opening cross-border banking establishments.\textsuperscript{150} The approval of any new banking establishment was contingent upon a multilateral agreement among regulators allowing each to gather the information necessary for effective supervision.\textsuperscript{151}

The Minimum Standards allocated supervisory responsibilities between home and host country regulators in a similar manner as the Revised Concordat, except in cases where the regulators decide that that allocation is inappropriate.\textsuperscript{152} If, in a particular situation, one

\textsuperscript{143} International Panel on Banking Revises Minimum Standards, Wall St. J., July 7, 1992, at C25. The Minimum Standards use the terms “home-country” and “host-country” in lieu of “parent” and “host.” See generally Minimum Standards, supra note 46.

\textsuperscript{144} Minimum Standards, supra note 46, at 3.

\textsuperscript{145} Id.

\textsuperscript{146} Id.

\textsuperscript{147} Id.

\textsuperscript{148} See id. at 3-4.

\textsuperscript{149} Minimum Standards, supra note 46, at 2.

\textsuperscript{150} Id. at 3. In determining whether to approve a foreign operation, the host-country regulator can consider the bank’s strength of capital, organization, and operating procedures for risk management. The home-country regulator, of course, should consider the same factors. Id. at 4.

\textsuperscript{151} Id. at 4-5.

\textsuperscript{152} Id.
regulator determined that such allocation was inappropriate, then it could reach an explicit agreement with its counterpart on a more appropriate allocation of supervisory responsibility.\textsuperscript{153} In the absence of an agreement to the contrary, the Minimum Standards continued to allocate supervisory responsibilities.\textsuperscript{154}

The host country regulator had responsibility for determining whether the international bank in fact would be subject to consolidated supervision in the home country.\textsuperscript{155} If the host country regulator found that the bank was not receiving effective supervision from the home country regulator, the host country regulator could prevent the opening of the new banking establishment.\textsuperscript{156} Alternatively, in its sole discretion, the host country regulator could allow the establishment of branches subject to any regulatory restrictions it deemed necessary and appropriate,\textsuperscript{157} but then would have to supervise any such establishment on a “‘stand alone’ consolidated basis.”\textsuperscript{158}

In a statement accompanying the issuance of the Minimum Standards, the Committee stated, “the minimum standards are designed to provide greater assurances that in the future no international bank can operate without being subject to effective, consolidated supervision.”\textsuperscript{159} The Minimum Standards themselves made clear that consolidated supervision is a fundamental regulatory principle adopted by the international bank supervisory community.\textsuperscript{160}

The new standards required that a single bank regulator exercise primary regulatory authority over an international bank.\textsuperscript{161} The minimum standards make home country regulators the primary regu-

\textsuperscript{153} See id. at 5.
\textsuperscript{154} Id. at 5–6.
\textsuperscript{155} See id. at 6. The host regulator should consider whether the bank is incorporated in a nation with which the host regulator has a mutual understanding for the exchange of information; whether the home-country regulator has given its consent for the new banking establishment; and whether the home-country regulator has the capability to perform consolidated supervision. Id. at 5–6.
\textsuperscript{156} Id. This course of action is not necessary if the home-country regulators are willing and able to “initiate the effort to take measures to meet these standards.” Id.
\textsuperscript{157} Minimum Standards, supra note 46, at 6.
\textsuperscript{158} Id. at 7.
\textsuperscript{159} Maggie Fox, Watchdog Writes Standards to Stop BCCI-type Frauds, REUTER BUS. REP., July 6, 1992, available in LEXIS, Nexis Library, WIRES File.
\textsuperscript{160} Minimum Standards, supra note 46, at 2.
\textsuperscript{161} This prevents any sort of collegial regulatory arrangement, similar to the one that attempted to supervise BCCI for several years. Learning from BCCI, Fin. TIMES LONDON, July 7, 1992, at 18. Specifically, the Minimum Standards state that all international banks “should be supervised by a home-country authority that capably performs consolidated supervision.” Minimum Standards, supra note 46, at 3.
lator of the foreign banking operations of banks incorporated in their jurisdictions.\textsuperscript{162}

The most important change in the new standards was formalization of the requirement that international banks receive permission from both home and host country regulators before opening foreign banking establishments.\textsuperscript{163} This double approval was designed to prevent the finger-pointing that had occurred in the past after a bank failure.\textsuperscript{164}

2. Gaps andWeaknesses in the Minimum Standards

Despite their improvements over past guidelines, the Minimum Standards contained a gap that banks could exploit to avoid regulation. A host regulator could still choose to allow a foreign banking establishment to operate in its jurisdiction even if the establishment’s home regulator did not comply with the Minimum Standards.\textsuperscript{165} The host country regulator need only impose the restrictions it deemed “necessary and appropriate” on this establishment.\textsuperscript{166}

Further, the standards focused on the establishment of new branches and did not explicitly address existing branches.\textsuperscript{167} Without an explicit statement in the new standards, retroactive application of the standards could vary by nation.\textsuperscript{168}

The Minimum Standards were designed to promote cooperation between home and host countries and encourage the flow of informa-

\textsuperscript{162} Erik Ipsen, Central Bankers Unveil New Anti-Fraud Rules, Int’l Herald Trib., July 7, 1992, at 9; see Minimum Standards, supra note 46, at 3.

\textsuperscript{163} See Minimum Standards, supra note 46, at 4; Ipsen, supra note 162, at 9.


\textsuperscript{165} Minimum Standards, supra note 46, at 6; see also Rod McNeil, Basel Group’s Bank Supervision Plan to Step Up International Coordination, Thomson’s Int’l Banking Reg., July 13, 1992, at 1, 1–2 (summarizing this provision).

\textsuperscript{166} Minimum Standards, supra note 46, at 6. The standards nevertheless require the host-country regulator to supervise the establishment adequately. See id.

\textsuperscript{167} Three of the Minimum Standards’ four principles apply solely to the creation of a new banking establishment. See id. at 3–6. The first principle (requiring adequate home-country consolidated supervision) is phrased as “a condition for the creation and maintenance of cross-border banking establishments” and arguably may apply to existing establishments. Id. at 3; see also Basle Committee on Banking Supervision Issues New Standards to Prevent Fraud, supra note 164, at A-1 (quoting Mr. Corrigan of the Committee as saying that Minimum Standards “would ‘by implication at least’ be able to be applied to existing branches”).

\textsuperscript{168} Learning from BCCI, supra note 161, at 18. This is expected to be a long and cumbersome process. Id.
tion among bank regulators. The standards were purposely vague, however, in order to allow regulators the flexibility to interpret them on a case-by-case basis.

Like the Concordat and the Revised Concordat, the Minimum Standards were not embodied in an enforceable treaty. The Committee, therefore, relied on regulators’ moral authority and informal pressure for enforcement. Furthermore, national regulators implemented the standards in isolation from one another, causing discrepancies in enforcement among nations. For instance, any penalties for violation of banking laws or regulations based on the standards rested with the individual country regulators.

Some critics argue that the Committee designed the Minimum Standards to prevent the development of large banks in emerging markets, and that banks in less developed nations would have the most difficulty meeting its requirements. While the Committee might have been concerned about emerging market banks operating in industrialized nations in the wake of BCCI, the Committee did not intend to limit the expansion of banks from emerging markets. Rather, the Committee intended to respond more effectively to large international bank failures.

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169 See, e.g., Minimum Standards, supra note 46, at 1–2 (encouraging cooperative efforts), 4–5 (conditioning establishment of cross-border banks on bilateral information exchange agreements).

170 Cf. id. at 2 (“The following four minimum standards are to be applied by individual supervisory authorities in their own assessment of their relations with supervisory authorities in other countries.”).


172 McNeil, supra note 165, at 1. The United Nations Center on Transnational Corporations also issued a report in light of the closure of BCCI. United Nations Ctr. on Transnational Corp., New Issues for Transnational Cooperation in Transnational Banking (1992); see Steve Lohr, U.N. Study Assails the Way B.C.C.I. Was Shut by Western Central Banks, N.Y. Times, Feb. 5, 1992, at D7. The report noted the massive losses caused by the bank’s closure and pointed out that the economic damage fell hardest on countries such as Nigeria and Bangladesh, where BCCI was an important institution. United Nations Ctr. on Transnational Corp., supra, at 13–14; Lohr, supra, at D7.


174 Cf. BIS Panel Lines Up Plans to Prevent New BCCIs, Institutional Investor Bank Letter, June 29, 1992, at 1, 9 (stating that the intent of Committee is to head off any future BCCI-type failures).

175 See id.
E. Core Principles for Effective Banking Supervision

The Basel Committee eventually developed more substantive standards for bank regulation. Rather than focusing merely on the coordination of international bank supervision, the Basel Committee provided comprehensive minimum standards for bank supervision when it published the Core Principles in 1997.176

After 1992, several prominent bank failures occurred. In March 1995, the venerable Barings Bank of London (“Barings”) failed after a trader in the Singapore operation, Nicholas Leeson, had lost over 927 million British pounds (US$ 1.1 billion) in the futures market in Singapore.177 Leeson took advantage of his position as both a trader and manager of the settlements operation in Barings’ Singapore office to hide his losses from his managers for several years.178 By the time these losses were discovered, they exceeded Barings’ capital. Despite intense negotiations, the Bank of England refused to support Barings, and the bank was put into receivership in February 1995 and subsequently sold to ING.179

Later in 1995, the Federal Reserve Board revoked the charter of the New York branch of the Daiwa Bank (“Daiwa”) because of its concealment of over US$ 1 billion in unrecorded trading losses incurred in the bond market.180 Daiwa had informed the Japanese Ministry of Finance of this information on August 8, 1995.181 The Ministry of Finance, however, delayed communicating the information to the Federal Reserve Board until September 18, 1995.182 The Federal Reserve promptly issued an order under the Foreign Bank Supervision Enhancement Act closing the Daiwa branch, which wound up its U.S. operations on February 2, 1996.183 The Daiwa closing preceded a 1997 financial crisis that spread across Asia and resulted in the closure

178 See id. at 307–09.
179 See id. at 323.
181 Id. at 216.
182 Id. at 217.
183 Id. at 215.
of many banks and the dramatic decrease in the gross national products of nations such as Thailand, Indonesia, and Malaysia.184

During this volatile period, the finance ministers and bank regulators of the G-7 were becoming uneasy about the stability of the international financial system. At the 1996 G-7 summit in Lyon, France, the leaders (through the Summit Communiqué) requested standard-setting bodies, including the Basel Committee, to draft more comprehensive and detailed financial standards.185 The leaders stated in the communiqué that:

[they] welcome the work accomplished by the international bodies concerned with banking and securities regulation . . . [and o]ver the year ahead, [authorities] should seek to make maximum progress on . . . encouraging the adoption of strong prudential standards in emerging economies and increasing cooperation with their supervisory authorities; international financial institutions and bodies should increase their efforts to promote effective supervisory structures in these economies.186

The Basel Committee responded to this call by issuing the Core Principles in September 1997, slightly over one year after the G-7’s request.187

The Core Principles set forth broad guidelines on best practices for bank supervision.188 The document does not merely deal with the coordination of supervision of internationally active banks. Instead, it details twenty-four guidelines for supervising entire national banking


188 See generally Core Principles, supra note 15 (presenting guiding principles for bank supervision).
systems from the licensing of banks to their closure due to insolvency. Only three of the twenty-five principles deal with cross-border banking, which previously had been the focus of the Basel Committee’s standard-setting work. The remainder set forth guidelines for the supervision of banks, even those without international operations. This document represented a major expansion of the Basel Committee’s work on bank supervision.

The twenty-five principles are divided into seven subject categories: preconditions for effective banking supervision (Principle 1), licensing and structure (Principles 2–5), prudential regulations and requirements (Principles 6–15), methods of ongoing banking supervision (Principles 16–20), information requirements (Principle 21), formal powers of supervisors (Principle 22) and cross-border banking (Principles 23–25). Although a detailed analysis of each principle is beyond the scope of this Article, a summary of some of the key provisions is relevant.

First, the Core Principles state that there are certain economic conditions necessary for an effective bank supervisory system. A nation must have sound macroeconomic policies, effective market discipline, a well-developed legal system, sound accounting principles, an orderly method for closing insolvent banks, and policies that promote financial system stability such as lender of last resort responsibility and depositor protection. Although bank supervisors generally do not create or implement these policies, sound macroeconomic conditions are vital to their ability to regulate banks effectively.

The Core Principles stress the need for the independence of bank supervisors, a sentiment echoed by several commentators. Supervisors require adequate resources both with respect to the number of staff and the independent, consistent funding to perform their jobs. Effective supervisory systems will “have clear responsibilities and objectives for each agency” involved in supervising banks.

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189 Id. at 41–43.
190 Walker, supra note 13, at 131–35.
191 Core Principles, supra note 15, at 11–12.
193 Das, supra note 192, at 13.
194 Id.
Unfortunately, many countries’ financial sector supervisors still do not enjoy adequate independence. For example, recent banking crises have involved connected lending between banks and their owners or related parties at favorable interest rates.\textsuperscript{195} Some of these borrowers used their political influence to prevent bank supervisors from forbidding or even questioning these loans.\textsuperscript{196} In a recent IMF survey of the bank systems, 45% of regulators in emerging markets were not operationally independent or lacked independent funding.\textsuperscript{197}

The language of the Core Principles sets forth the best practices of bank supervision in broad terms. For instance, the Core Principles state that supervisors should set “limits to restrict bank exposures to single borrowers” or “groups of related borrowers.”\textsuperscript{198} In the comments to the Core Principles, the drafters indicate that 25% of capital should be the maximum limit of a bank’s exposure to a single borrower,\textsuperscript{199} but this is not an absolute limit.\textsuperscript{200} Similarly, the Core Principles state that supervisors must ensure that banks “have adequate policies, practices and procedures, including strict ‘know-your-customer’ rules, that promote high ethical and professional standards.”\textsuperscript{201} The Core Principles do not specifically define such rules, other than referring to the more detailed Financial Action Task Force on Money Laundering recommendations.\textsuperscript{202} This vagueness of language was necessary for the various Basel Committee members to reach agreement on the Core Principles, and to encourage several regional groups of bank supervisors to endorse them.\textsuperscript{203}

In addition to the members of the Basel Committee, bank supervisory agencies from non-G-10 nations endorsed the Core Principles.\textsuperscript{204} Representatives from Chile, the People’s Republic of China,

\textsuperscript{195} Heimann, \textit{supra} note 192, at 66; Kenen, \textit{supra} note 184, at 7.
\textsuperscript{196} Heimann, \textit{supra} note 192, at 66.
\textsuperscript{198} \textsc{Core Principles}, \textit{supra} note 15, at 26.
\textsuperscript{199} \textit{Id.}
\textsuperscript{200} \textit{Id.}
\textsuperscript{201} \textit{Id.} at 39 (Principle 15).
\textsuperscript{204} \textsc{Core Principles}, \textit{supra} note 15, at 1.
the Czech Republic, Hong Kong, Mexico, Russia, and Thailand participated in the drafting process, while officials from Argentina, Brazil, Hungary, India, Indonesia, the Republic of Korea, Malaysia, Poland, and Singapore participated closely in the Core Principles’ development.\textsuperscript{205} The Core Principles thus represented one of the first major Basel Committee projects that involved significant participation by non-G-10 nations at the drafting stage. This addressed the recurring criticism that the Basel Committee was exclusively a “rich countries” club.\textsuperscript{206}

Besides direct participation during the drafting process, a significant number of nations endorsed the Core Principles after they were issued. At the October 1997 annual meeting of the International Monetary Fund (“IMF”) and the International Bank for Reconstruction and Development (“World Bank”), the Core Principles were endorsed by the attending nations.\textsuperscript{207} The Group of 22 endorsed the Core Principles, along with other international financial standards, in an October 1998 report.\textsuperscript{208} In the same month, the International Conference of Banking Supervisors endorsed the Core Principles and pledged to implement them during their biennial conference.\textsuperscript{209}

As nations began to implement the Core Principles, it became clear that bank supervisors needed additional guidance and explanation. In order to provide such guidance, the Basel Committee issued the Core Principles Methodology (“Methodology”) in 1998.\textsuperscript{210} As the Committee noted, “[x]perience has already shown that the Principles may be interpreted in widely diverging ways, and incorrect interpretations may result in inconsistencies among assessments.”\textsuperscript{211} The Methodology restated the language of each of the twenty-five principles, and then went on to describe criteria to be used in assessing whether a particular nation has effectively implemented that principle. The criteria were divided into two groups: (1) essential criteria that are the minimum level of implementation needed for compliance, and (2) additional criteria that represent the best practice of

\begin{thebibliography}{9}
\bibitem{205} Id. at 1–2.
\bibitem{207} \textit{Core Principles Methodology}, \textit{supra} note 16, at 3.
\bibitem{208} Id.
\bibitem{209} Id.
\bibitem{210} See id. at 1.
\bibitem{211} Id.
\end{thebibliography}
Because of its detail, the Methodology has become the more influential and useful document among bank supervisors.

F. Gaps in the Core Principles

Despite its breadth and specificity compared to other Basel Committee documents, the Core Principles did not address some important issues in the bank supervisory system. First, they did not specifically address whether a country should have a deposit insurance scheme. Although, the Core Principles discuss a systemic safety net as a precondition to effective supervision, they do not include a specific requirement for deposit insurance. The Annex to the Core Principles addresses this issue, and makes no recommendation regarding deposit insurance. It merely highlights the possibility that deposit insurance increases the “risk of imprudent behaviour” by banks and stresses that any deposit insurance program “should be tailored to the circumstances in, as well as historical and cultural features of, each country.”

Furthermore, the Basel Committee did not make any recommendation regarding the best organizational structure for bank supervision. Numerous commentators and policymakers, however, have already dealt with this issue. For instance, one study considered whether there should be a single financial sector regulator similar to the Financial Services Authority in the United Kingdom. Another discussed whether bank supervisory functions should be part of the central bank, which has lender of last resort responsibility, or whether they should be separated to avoid any potential conflict of interest. Australia adopted a “four peaks” approach, allocating regulatory responsibility to each agency by objective: financial stability, prudential

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212 Core Principles Methodology, supra note 16, at 2.
213 See id. at 7.
214 See id.
215 Core Principles, supra note 15, at 44.
216 Id.
217 Id.
supervision, consumer protection, and competition.\textsuperscript{221} Since commentators and influential policymakers have not agreed on a best structure, it is not surprising that the Basel Committee did not make any recommendation on this topic.\textsuperscript{222}

Nor could the Basel Committee agree on common bank accounting standards. Principle 21 of the Core Principles recognizes the importance of proper financial reporting that reflects the operations of banks in a fair, consistent manner.\textsuperscript{223} Furthermore, some commonality of accounting methods among nations is necessary for effective consolidated supervision of international banks, because differing accounting standards make monitoring banks’ financial operations in different nations difficult.\textsuperscript{224} Nevertheless, the Basel Committee was unable to agree on substantive rules for accounting standards.\textsuperscript{225} It appears that more substantive harmonization of bank accounting standards will be left for a future revision of the Core Principles.

With the issuance of the Revised Capital Accord, however, the Basel Committee has resources available to focus on revising the Core Principles. In any such revision, the Basel Committee should strengthen the principle on bank accounting standards. While the Committee has commented regularly on the work of the International Accounting Standards Board and the International Auditing and Assurance Standards Board,\textsuperscript{226} the Committee still must provide further detail on such standards in order to improve the compatibility of bank financial reports among nations.\textsuperscript{227}

\textsuperscript{222} Lastra, \textit{supra} note 218, at 50.
\textsuperscript{223} \textit{Core Principles}, \textit{supra} note 15, at 35–36; \textit{Core Principles Methodology}, \textit{supra} note 16, at 43.
\textsuperscript{225} \textit{Core Principles}, \textit{supra} note 15, at 36.
\textsuperscript{226} \textit{See Bank for Int’l Settlements, supra} note 34, at 168.
\textsuperscript{227} \textit{See generally} Charlie McCreevy, European Commissioner for Internal Market and Services, From Quantity to Quality: The Future of Internal Market Regulation, European Policy Centre Breakfast Policy Briefing (Apr. 7, 2005), at http://www.exchange-handbook.co.uk/news_story.cfm?id=52266 (putting forth a similar argument).
G. Revised Capital Accord

As noted above, the Basel Committee issued another major international financial standard relevant to the Core Principles—the Revised Capital Accord.228 This complex document sets forth various methods whereby internationally active banks can calculate a bank’s minimum required capital.229 Although a detailed analysis of this document is beyond the scope of this Article, certain provisions are relevant to this discussion because they may create an incentive for nations to implement the Core Principles.230

The Revised Capital Accord consists of three policy objectives or “pillars.”231 The first pillar describes the two principal methods available for calculating minimum capital levels for banks: the standardized approach that establishes categories for different types of risk, and the internal ratings-based approach that allows banks to use their own internal risk valuation method.232 The theory underlying risk valuation is that a particular bank asset or loan will be evaluated for risk, and a particular weight will be applied to that asset in order to calculate the total risk-weighted assets of the bank.233

The original Capital Accord provided a very simple method of calculating minimum capital using risk weight categories.234 Loans to countries who are OECD members received a risk weight of 20%; loans to nations outside of the OECD received a risk weight of 100%.235 This meant that banks could allocate less capital to loans to OECD governments or banks incorporated in OECD countries. The Revised Capital Accord provides for a much more sophisticated and complicated method.

228 Revised Capital Accord, supra note 48.
229 See Capital Adequacy Standards, supra note 45, at 1.
230 See infra notes 430–447 and accompanying text.
231 Revised Capital Accord, supra note 48, para. 4.
232 Id. paras. 50–51.
233 See id.
234 Capital Adequacy Standards, supra note 45, at 7–8. The 1988 Capital Accord was 26 pages of text compared to the Revised Capital Accord with 251 pages of text. Id.
The second pillar of the Revised Capital Accord refers to the prudential supervision of the risk valuation method chosen.\textsuperscript{236} In the prior Capital Accord, only one method of calculating minimum capital was available.\textsuperscript{237} In the Revised Capital Accord, two principal methods are available.\textsuperscript{238} Bank supervisors must understand and approve the method selected by each particular bank.\textsuperscript{239}

The third pillar calls for using market discipline to enforce the Revised Capital Accord.\textsuperscript{240} The Basel Committee recommends that banks disclose both their valuation method in general terms and their capital levels to depositors and the general public.\textsuperscript{241} The market can then evaluate the method chosen and the amount of capital retained by the bank and reflect any risk in the stock price of the particular bank.\textsuperscript{242}

The changes to the formula for calculating minimum capital, particularly the standardised approach in Pillar I, are relevant to this discussion. In determining the risk weight for credits to sovereign and corporate borrowers, banks can refer to external credit assessments from rating agencies\textsuperscript{243} such as Standard & Poor’s, Moody’s, or Fitch, or ratings from export credit insurance agencies.\textsuperscript{244} These agencies and their analysts take compliance with the Core Principles and other international financial standards into account when determining each country’s sovereign credit rating.\textsuperscript{245} Countries that comply with international financial standards, such as the Core Principles, tend to receive more favorable sovereign credit ratings.\textsuperscript{246} A favorable credit rating places a country in a lower risk weight category.\textsuperscript{247} Therefore, countries that comply with international financial standards, and the banks located therein, will benefit from lower interest rates on loans, because banks will be able to allocate less capital to a loan placed in a

\textsuperscript{236}Revised Capital Accord, supra note 48, para. 719.
\textsuperscript{237}Capital Adequacy Standards, supra note 45, at 7–8.
\textsuperscript{238}Revised Capital Accord, supra note 48, para. 7.
\textsuperscript{239}Id. paras. 720–24.
\textsuperscript{240}Id. para. 809.
\textsuperscript{241}Id. para. 810.
\textsuperscript{242}See id. para. 809.
\textsuperscript{243}Revised Capital Accord, supra note 48, paras. 52–55, 66–68.
\textsuperscript{244}Id.
\textsuperscript{245}John Chambers, The Importance of the IMF’s Work on Standards and Codes, Speech to the Annual Meeting of the IMF/IBRD (Sept. 2002), in Ratings Direct (2002); E-mail regarding Sovereign Ratings from Richard Fox, Senior Director of the Sovereign Team at Fitch Ratings, to Duncan E. Alford, Head of Reference, Georgetown University Law Library (July 15, 2004) (on file with author).
\textsuperscript{246}See Chambers, supra note 245.
\textsuperscript{247}See Revised Capital Accord, supra note 48, para. 52.
lower risk weight category. A more detailed discussion of the effects of the Revised Capital Accord on enforceability of the Core Principles follows.

II. Implementation

As mentioned above, the Core Principles are a statement of best practices expressed as guidelines. Like other Basel Committee documents, they do not have the force of law and must be implemented at the national level. As such, implementation of the Core Principles has varied significantly by nation. While most developing nations have implemented the Core Principles to a large extent, emerging markets and transition economies have only done so to a more limited degree. This section highlights the implementation of the Core Principles in selected important financial markets: the European Union, the United Kingdom, France, Hong Kong, and the United States.

A. European Union

Among the objectives of the European Union (“EU”) are the creation of an internal market and the dismantling of internal trade restrictions. The creation of this internal market for financial services has been more difficult and problematic than for manufactured goods. In the 1998 European Council meeting in Vienna, the leaders of the EU called for the prompt integration of the financial services sector among member nations. Subsequently, the European Commission proposed a Financial Services Action Plan that outlined the steps (including forty-two legislative measures) to complete the creation of an internal market for financial services. As of June 2004, nearly all the required legislation at the EU level had been enacted.

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252 See European Comm’n, Turning the Corner: Preparing the Challenge of the Next Phase of European Capital Market Integration 1 (June 2, 2004), at http://europa.eu.int/comm/internal_market/en/finances/actionplan/progress10_en.pdf. The principle type of legislation used to implement the FSAP was the the directive. See generally Klaus-Dieter Borchardt, The ABC of Community Law (2000) (giving a basic description of the legislative process and the types of EU legislation).
Nevertheless, member nations have yet to enact legislation at the national level to implement the various EU directives. Certain Financial Services Action Plan directives are related to the Core Principles, including the Regulation on the Application of International Accounting Standards and the Directive on Supplementary Supervision of Credit Institutions.

The supervision of banks within the EU is primarily the responsibility of member states and is not conducted at the EU level. The European Central Bank ("ECB") along with the European System of Central Banks ("ESCB") controls monetary policy for the member states that are part of the European Monetary Union. The ECB does not, however, have direct responsibility for the supervision of banks within the EU. Under the Treaty on European Union ("Treaty"), the ECB can only aid in the smooth operation of prudential supervision of banks. The Treaty does contain a special provision allowing the ECB to assume prudential supervision over banks, but this authority requires a unanimous approval from Member States that would be nearly impossible to obtain. The proposed constitutional treaty does not change this structure. Overall, banking law at the EU level currently has little substantive influence on bank supervision within the EU. Most bank supervisory practice is provided for in the national law of the Member States.

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253 European Comm’n, supra note 252, at 1.
258 EC Treaty art. 105(5).
259 Id. art. 105(6); see Tom de Swaan, The Changing Role of Banking Supervision, 6 Econ. Pol’y Rev.75, 78 (2000); Lastra, supra note 218, at 56–57.
Nevertheless, the EU is in the midst of restructuring its financial regulatory agencies in order to further integrate the financial services sector within the EU. As part of the Financial Services Action Plan, the European Commission asked a group of prominent politicians involved in monetary and economic affairs (“Committe of Wise Men”) to report on improving the regulation of the securities markets in the EU.261 Led by Alexandre Lamfalussy, the Committee of Wise Men issued a report (“Report of the Wise Men”) recommending changes in the enactment of legislation governing the securities markets in Europe.262 The Report of the Wise Men developed a new legislative process (“Lamfalussy Process”), originally intended for the securities markets, that the European Commission has recommended be extended to the other parts of the financial services sector—namely, banking and insurance.263 The European Council and the European Parliament have in turn agreed on a Directive that applies the Lamfalussy Process to the banking and insurance sectors.264

The Lamfalussy Process creates four levels of lawmaking to implement policy and enact laws governing the financial services sector.265 A weakness of the current EU legislative procedure is the amount of time required to enact legislation after it has been proposed by the European Commission, especially when using the predominant method of enacting EU legislation, the codecision procedure.266 A period of two to two and a half years is not uncommon for

266 See EU, Key Players in EU Legislation, at http://europa.eu.int/eur-lex/en/about/pap/index.html (last updated Apr. 27, 2004). A detailed description of the codecision procedure used to enact EU legislation is beyond the scope of this article. Generally code-
enacting legislation.\textsuperscript{267} Level I of the Lamfalussy Process involves the adoption of directives and regulations using the codecision procedure at the EU level.\textsuperscript{268} Level II involves the implementation of the law by providing additional details.\textsuperscript{269} This level is analogous to the rulemaking by U.S. administrative agencies such as the Comptroller of the Currency or the Federal Deposit Insurance Corporation. The Report of the Wise Men recommended that a special committee of national supervisory officials be created to develop these details.\textsuperscript{270} Level III refers to greater cooperation among national supervisors to “ensure consistent enforcement and implementation.”\textsuperscript{271} As with Level II, the Report of the Wise Men recommended the creation of a committee to coordinate supervisory practice among EU member states.\textsuperscript{272} Level IV refers to more effective enforcement of EU laws.\textsuperscript{273}

Level II and Level III are being implemented by committees established by the European Commission. The European Commission has created the European Banking Committee (formerly the Banking Advisory Committee) as a Level II committee.\textsuperscript{274} In addition, in January 2004, the Council created the Committee of European Banking Supervisors as a Level III committee.\textsuperscript{275} This committee will coordinate bank supervisory practices so as to create a level playing field for banks within the EU.\textsuperscript{276} These committees are so new that there is little basis upon which to evaluate their effectiveness. The EU is clearly attempting to centralize banking supervision as much as possible within the legal decision requires agreement among the Council of the European Union and the European Parliament before legislation becomes law. See id.\textsuperscript{267} See Kees Van Dijkhuizen, \textit{A Functional Approach to Fifty Years of Banking Supervision, in Banking Supervision at the Crossroads} 44, 51 (Thea Kuppens ed., 2003).

\textsuperscript{268} ECOFIN, 10th FSAP Progress Report 11, available at http://europa.eu.int/comm/internal_market/finance/docs/actionplan/index/progress10_en.pdf (last visited May 4, 2005). Directives are a type of EU legislation that sets out the objectives of the law but requires member states to enact national legislation to implement the law. See Borchardt, \textit{supra} note 252, at 63–71.

\textsuperscript{269} \textit{WISE MEN REPORT, supra} note 262, at 28.

\textsuperscript{270} See id. at 28–35.

\textsuperscript{271} Id. at 37.

\textsuperscript{272} See id. at 37–38.

\textsuperscript{273} See id. at 40.

\textsuperscript{274} European Comm’n, Decision Establishing the European Banking Commission, 2004 O.J. (L3) 36–37.

\textsuperscript{275} European Comm’n, Decision Establishing the Committee of European Banking Supervisors, 2003 O.J. (L3) 28.

\textsuperscript{276} Jose Maria Roldan, Chair of the Committee of European Banking Supervisors, Establishment of the Committee and Future Challenges, Speech to Members of the Economic and Monetary Affairs Committee of the European Banking Federation (Apr. 26, 2004), available at http://www.c-ebs.org/speeches/SP2.htm.
limits of the treaty.\textsuperscript{277} A clear trend within EU law on financial services is the increased centralization of bank regulation within the EU. Nevertheless, although the EU is moving towards more involvement in bank and financial services supervision and regulation, most supervision of banks operating within the EU still occurs at the national level.

B. United Kingdom

The United Kingdom is not part of the European Monetary Union and has maintained its own independent currency, the pound sterling. In 2000, the British Parliament radically reorganized the agencies supervising and regulating the financial services sector by enacting the Financial Services and Markets Act of 2000.\textsuperscript{278} Nine separate agencies that regulated the securities, banking, and insurance sectors were merged into one regulatory agency—the Financial Services Authority (“FSA”).\textsuperscript{279} The Bank of England continues to be responsible for monetary policy and serves as the lender of last resort, but its supervisory function has been wholly transferred to the FSA.\textsuperscript{280} The failures of BCCI and Barings hurt the credibility of the Bank of England as a supervisor and prompted Parliament, at least in part, to strip the Bank of England of its supervisory function.

The United Kingdom has an active, well-developed financial sector and is particularly strong in international finance.\textsuperscript{281} Its stock market is the third largest in the world in terms of market capitalization.\textsuperscript{282} The bank supervisory system in the United Kingdom is similarly well-developed and sophisticated, as confirmed by the IMF. In 2003, the IMF evaluated the soundness and stability of the United Kingdom’s financial system as part of its Financial Sector Assessment Program (“FSAP”).\textsuperscript{283} Under the FSAP, the IMF sends an inspection

\textsuperscript{277} Antonio Sainz de Vicuna, \textit{The ESCB and its Role in Banking Supervision}, 34 \textit{Int’l L. \& \textbf{117, 118} (2000). ECB would like to have clear bank supervisory authority. See id.}
\textsuperscript{278} See Financial Services and Markets Act, 2000, c. 8 (Eng.).
\textsuperscript{281} \textsc{Economist Intelligence Unit}, \textit{Country Profile: United Kingdom} \textbf{40} (2004).
\textsuperscript{282} U.S. Census Bureau, \textit{Statistical Abstract of the United States} \textbf{872 tbl.1376 (2003).}
team of financial regulators to evaluate and critique each country’s financial system, with the aim of improving the soundness of each country’s financial system and enhancing the stability of the international financial system as a whole. As part of this assessment, the inspection team also evaluates the implementation of key financial standards, including the Core Principles.

The 2003 FSAP report concluded that the supervisory system in the United Kingdom is state of the art and fully complies with the Core Principles. The report determined that the FSA had clear regulatory objectives, was independent, and was separately funded by industry assessments. Thus, the FSA structure met the independence requirement of Principle 1 of the Core Principles. The FSA controlled licensing of banks, and British law limited use of the term “bank.” Likewise, the FSA had the legal authority to approve the transfer of control of financial institutions.

The report did, however, make some minor recommendations. Adequate staff resources are part of the independence requirement of the Core Principles. The inspection team, however, noted that there were relatively few bank supervisory personnel in the FSA, and the staff available to supervise the market operations of banks was thin compared to those supervising securities firms. Also, the report recommended additional reporting by banks to the FSA, in particular, reports on nonperforming loans, capital adequacy, and other supervisory financial ratios. The FSA, in its reply to the Assessment Report, generally agreed with the conclusions, but noted that, in its opinion, current supervisory practices met the concerns expressed in the report.

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286 See U.K. FSAP REPORT, supra note 283, at 1.
287 Id. at 60.
288 Id.; see CORE PRINCIPLES, supra note 15, at 1.
289 U.K. FSAP REPORT, supra note 283, at 60.
290 Id.
292 See U.K. FSAP REPORT, supra note 283, at 62.
293 Id.
294 Id.
295 Id. at 65.
Overall, the United Kingdom is in full compliance with the Core Principles. The FSAP assessment report only raised some minor issues involving reporting and adequate staffing, neither of which rose to a level of non-compliance. In addition, an independent, non-profit, standards–monitoring organization has rated the United Kingdom second in the world with respect to compliance with twelve key standards, including the Core Principles.296

C. France

Unlike the United Kingdom, France has chosen a sector-based regulatory scheme with separate agencies supervising banking, securities, and insurance.297 The banking system in France is regulated by three separate governmental agencies: le Comité des Etablissements de Credit et des Enterprises d’Investissement (“CECEI”), the Commission Bancaire (“Commission”), and the ministre chargée de l’Economie et des Finances (the Ministry of Economy, Finance, and Industry).298 Before August 2003, an independent agency, la Comité de la Réglementation Bancaire et Financière, regulated bank competition, but the law enacted in August 2003 transferred its powers to the Ministry of Finance.299 The Bank of France (la Banque de France) governs monetary policy in a manner similar to that of the Bank of England and the Federal Reserve Board in the United States. The CECEI primarily administers the licensing of banks and the authorization of foreign banking establishments to operate in France.300 The Commission is the primary agency responsible for bank supervision in France.301

The Commission is composed of six members and is chaired by the Governor of the Bank of France.302 The Director of the Treasury


301 NEAU-LEDUC, supra note 298, at 59.

is a member of the Commission.\textsuperscript{303} There are four other members nominated by the Ministry of the Economy, Finance, and Industry, one of whom is generally an advisor to the Conseil d’état and another is an advisor to the Cours de Cassation.\textsuperscript{304} The other two members are selected based on their expertise in monetary and banking law.\textsuperscript{305} These four nominated members serve terms of six years.\textsuperscript{306} The Commission supervises credit institutions for financial soundness and compliance with banking law.\textsuperscript{307} The Commission has extensive enforcement powers, from the imposition of fines to the mandatory liquidation and closure of banks.\textsuperscript{308} The Commission relies to a certain degree on personnel of the Bank of France, or outside auditors, to conduct bank inspections.\textsuperscript{309}

The IMF conducted an FSAP assessment of France during 2004.\textsuperscript{310} The assessment report issued to the public in November 2004 found that France generally complied with international standards and confirmed its “financial sector is strong and well-supervised.”\textsuperscript{311} The report did note, however, that France should strengthen the cooperation among various regulatory agencies and monitor the potentially risky expansions of certain French banks into both financial and non-financial enterprises.\textsuperscript{312} Currently, banks may acquire non-financial enterprises without the approval of CECEI.\textsuperscript{313} The FSA recommended that the CECEI be granted the power to supervise any expansion into non-financial industries.\textsuperscript{314} The report also criticized the administrative intervention of the French government into the banking market, particularly the setting of the deposit interest rates and the maximum interest rate on loans.\textsuperscript{315}

The FSAP assessment also indicated that, given the institutional structure of the French bank regulatory agencies, the independence

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\textsuperscript{303} Neau-Leduc, \textit{supra} note 298, at 60.  \\
\textsuperscript{304} Id.  \\
\textsuperscript{305} Id.  \\
\textsuperscript{306} French Banking Act, art. 38; Neau-Leduc, \textit{supra} note 298, at 60.  \\
\textsuperscript{307} Neau-Leduc, \textit{supra} note 298, at 60.  \\
\textsuperscript{308} Id. at 64–65.  \\
\textsuperscript{309} Id. at 61. \\
\textsuperscript{311} FSSA France, \textit{supra} note 297, at 3.  \\
\textsuperscript{312} France Consultation, \textit{supra} note 310, at paras. 16–17.  \\
\textsuperscript{313} FSSA France, \textit{supra} note 297, at 29.  \\
\textsuperscript{314} Id. \\
\textsuperscript{315} See France Consultation, \textit{supra} note 310, at para. 17.
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of the bank supervisor is questionable. The Bank of France and the Treasury have permanent seats on the Commission Bancaire and the other members are appointed by the Ministry of the Economy. While the members do have fixed terms, the executive branch has extensive control over the membership of the Commission. In addition, the Commission relies to a significant degree on personnel over whose activities the Commission has no direct control. Furthermore, Bank representatives serve on the board of the CECEI, creating potential conflicts of interest. These factors detract from the independence of the bank regulator as compared to Great Britain. Principle 1 of the Core Principles refers to the independence of the regulator, both operationally and with respect to funding and adequate staffing levels.

Overall, France is in compliance with the Core Principles, though the independence of the regulator may be weaker than in other G-7 nations. An independent assessment group has ranked France nineteenth in the world with respect to compliance with international financial standards.

D. Hong Kong Special Administrative Region

The Hong Kong Special Administrative Region (“SAR”) is a major global financial center. Its stock market is ranked fifth by market capitalization in the world and nearly every major international bank maintains an office in Hong Kong. Although Hong Kong had been a British colony since the 19th century and ruled by a governor appointed by the British crown, sovereignty over Hong Kong was transferred by Great Britain to the People’s Republic of China in

316 FSSA France, supra note 297, at paras. 44–45.
317 Id.
318 Id.
319 Id. at para. 45.
320 Core Principles, supra note 15, at 1.
1997. The fundamental legal document now governing Hong Kong is the Basic Law. The Legislative Council in Hong Kong enacts laws with the approval of the Chief Executive, including the Banking Ordinance that governs the structure of the bank regulatory agencies and provides for the supervision of banks.

Banks dominate the credit markets in Hong Kong. The three largest banks account for 57% of deposits. The banking market takes on an oligopolistic character and, until 2000, operated like a cartel. Deposit interest rate setting by the larger banks was phased out in 2001.

Regulation of the financial services market in Hong Kong is organized by traditional sectors—banking, insurance, and securities. The Hong Kong Monetary Authority ("HKMA") is the principal supervisor of banks in Hong Kong, as well as those organized or operating therein. In addition, the HKMA implements monetary policy and supervises the payment and settlements system.

In 2002, the IMF conducted an FSAP inspection of Hong Kong. The report concluded that Hong Kong's financial system is "resilient, sound and overseen by a comprehensive supervisory framework." Hong Kong bank supervisors were adequately financed and had appropriate enforcement powers to comply with the Core Principles. No bank failures occurred in Hong Kong from 1993 through 2003.

According to the assessment report, the primary weakness of the bank supervisory structure in Hong Kong is the lack of independence of the HKMA. The procedures for appointment, compensation,

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327 HK FSAP REPORT, supra note 322, at 17.
329 See HK FSAP REPORT, supra note 322, at 18.
330 Id. at 23.
332 See id.
333 HK FSAP REPORT, supra note 322, at 1.
334 Id.
335 Id. at 8.
336 See id.
337 See id. at 9.
dismissal, and terms of office of the senior HKMA officials are not explicit and need to be so.\textsuperscript{338} In addition, current legislation does not delineate the HKMA’s regulatory and supervisory responsibilities, nor its monetary policy objectives.\textsuperscript{339}

Good bank supervisory governance is characterized by independence, accountability, transparency, and integrity. According to the FSAP assessment, Hong Kong’s banking regime needs improvement with respect to the first three.\textsuperscript{340} The Financial Secretary appoints the head of the HKMA.\textsuperscript{341} The “procedures for appointment, terms of office, and grounds for dismissal” of the head of the HKMA are not explicitly provided in legislation.\textsuperscript{342} The Financial Secretary can exempt persons from the Banking Ordinance without limitation.\textsuperscript{343} HKMA lacks a board that oversees its regular operations.\textsuperscript{344} Any appeal of a supervisory order issued by the HKMA goes to the Chief Executive of the SAR, a political official.\textsuperscript{345}

Articles 109 and 110 of the Basic Law vest responsibility for financial market supervision in the government.\textsuperscript{346} The executive branch is predominant in the Hong Kong government, and the Chief Executive has a reserve power to direct statutory bodies, including the HKMA, to take certain actions.\textsuperscript{347} There are few publicly disclosed limits on this reserve power.\textsuperscript{348} The Chief Executive could, for instance, direct the HKMA to issue a banking license or forbid them from revoking a banking license. Section 11 of the Securities and Futures Ordinance, which regulates the securities market, sets conditions on the use of this reserve power in the context of securities regulation.\textsuperscript{349} The FSAP assessment team recommended that similar limits

\textsuperscript{338} Id.  
\textsuperscript{339} See id.; cf. EC Treaty art. 105 (noting that the European Central Bank’s primary objective is price stability).  
\textsuperscript{340} HK FSAP REPORT, supra note 322, at 33.  
\textsuperscript{341} Id.  
\textsuperscript{342} Id. The insurance supervisory agencies are part of the Financial Services and Treasury Bureau. Id. They are part of the Hong Kong government and are therefore not independent. Id.  
\textsuperscript{343} See id.; Banking Ordinance, Laws of Hong Kong, c. 155, § 13.  
\textsuperscript{344} HK FSAP REPORT, supra note 322, at 34. The Banking Advisory Committee advises the Chief Executive on bank regulation and how it affects business activities of banks. The Financial Secretary chairs this Committee.  
\textsuperscript{345} Id.  
\textsuperscript{346} Basic Law, supra note 325, arts. 109–110, 29 I.L.M. at 1537.  
\textsuperscript{347} HK FSAP REPORT, supra note 322, at 34.  
\textsuperscript{348} See id.  
\textsuperscript{349} Securities and Futures Ordinance, Laws of Hong Kong, c. 571, § 11 (2003).
be placed on the use of the reserve power by the Chief Executive in the bank regulatory arena.  

Thus, Hong Kong’s primary deficiency in complying with the Core Principles is the HKMA’s lack of independence. The Chief Executive of the SAR can intervene in any matter under the Banking Ordinance. While the Chief Executive has never used this reserve power, its “presence poses a potential threat to supervisory independence” and raises the serious possibility of government interference into bank supervisory matters. Such concerns are particularly relevant in light of recent outcries over sedition laws proposed by the government, as well as other perceived abuses of power.

The HKMA vehemently disagreed with the FSAP Report’s analysis of regulatory independence. The HKMA argues that the Chief Executive has never used the reserve power and will only use it as a last resort. The restraint on this power is “deeply embedded,” and any abuse of the power would be “politically untenable.” This response, however, was written prior to the recent introduction of the sedition law by the Hong Kong government and the subsequent mass protests against the Hong Kong government’s perceived abuse of power.

The FSAP report also noted that regulatory arrangements regarding the financial system are “strongly reliant on personal relationships and understanding at the level of agency heads and the government.” In order to clarify such arrangements, the relevant agencies should issue a clear statement of policy regarding their relationship in times of financial stress, as well as a public disclosure of the specific roles of the various regulatory agencies.

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350 HK FSAP Report, supra note 322, at 34–35.
351 Id. at 39.
352 Id.
354 See HK FSAP Report, supra note 322, at 41.
355 Id.
356 Id.
357 See The Parade Gets Rained On, supra note 324, at 8; A Bill Too Far, supra note 353, at 7.
358 HK FSAP Report, supra note 322, at 35.
Regarding financial system stability, Hong Kong currently has no deposit insurance scheme.\textsuperscript{360} While a deposit insurance scheme is not a requirement under the Core Principles, it is listed as a technique or tool to enhance financial system stability.\textsuperscript{361} A bill establishing a deposit insurance system was enacted by the Legislative Council with a plan to commence operations in 2006.\textsuperscript{362}

Overall, Hong Kong is in compliance with the Core Principles, although substantial issues have been raised with respect to the independence, accountability, and transparency of its banking regulation system. An observer of the compliance of international standards ranks Hong Kong sixth in the world.\textsuperscript{363}

\textbf{E. United States}

The United States has the largest financial services market in the world.\textsuperscript{364} The complex structure of bank regulation in the United States matches the complexity and size of its financial services market. The hallmark of the U.S. banking system is its dual nature; banks can be chartered either by individual states or by the U.S. government.\textsuperscript{365} While this dual banking system creates a complex licensing and supervisory system, it is unlikely to change. In recent years, the U.S. Congress has concentrated regulatory authority over foreign bank operations and complex financial organizations at the national level with the Federal Reserve System.\textsuperscript{366}

At the federal level, there are three primary bank supervisors in the United States: the Federal Reserve System Board of Governors ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC").\textsuperscript{367} The Federal Reserve governs monetary policy and supervises certain institutions within the U.S. banking system—members of the Federal Reserve system, financial holding companies, and foreign banks operating in the United States.\textsuperscript{368} Each of the Governors of the Federal Re-

\textsuperscript{360} HK FSAP Report, \textit{supra} note 322, at 39.
\textsuperscript{361} Core Principles, \textit{supra} note 15, at 46.
\textsuperscript{362} Deposit Protection Scheme Ordinance, Laws of Hong Kong, c. 581; \textit{see} Insurance for a Rainy Day, S. China Morning Post, May 20, 2004, at 1, \textit{available at} 2004 WLNR 5971605.
\textsuperscript{363} EStandards Forum Weekly Report, \textit{supra} note 296, at 11.
\textsuperscript{364} U.S. Census Bureau, \textit{supra} note 282, at 872.
\textsuperscript{365} 1–1 Banking Law § 1.04 (Matthew Bender ed. 2004).
\textsuperscript{366} Schooner, \textit{supra} note 280, at 411–12.
serve, including the Chairman, are appointed by the President of the United States for fourteen year terms, subject to confirmation by the U.S. Senate.\textsuperscript{369}

The Comptroller of the Currency supervises national banks.\textsuperscript{370} National banks are credit institutions that have sought a federal charter under the National Bank Act, rather than a banking license from a particular state.\textsuperscript{371} The Comptroller of the Currency is appointed by the President for a five year term and confirmed by the U.S. Senate.\textsuperscript{372} The OCC, part of the U.S. Department of the Treasury, issues regulations on the permissible activities of national banks, conducts on-site and off-site inspections, and has comprehensive enforcement authority.\textsuperscript{373}

The FDIC provides deposit insurance to member banks, for which they pay an insurance premium.\textsuperscript{374} The FDIC also issues regulations governing the activities of member banks, both federally and state-chartered, and has comprehensive enforcement powers over its members.\textsuperscript{375} The FDIC is governed by a five member board, one of whom is the Comptroller of the Currency, one of whom is the Director of the Office of Thrift Supervision, and the other three of whom are appointed by the President with the consent of the Senate.\textsuperscript{376} The appointed directors of the Board serve six year terms. The Chairman of the FDIC is chosen from these three appointed directors and serves a five year term.\textsuperscript{377}

Other types of financial institutions are supervised by separate regulatory agencies. The National Credit Union Association supervises credit unions,\textsuperscript{378} and the Office of Thrift Supervision supervises savings and loan associations.\textsuperscript{379}

The Gramm-Leach-Bliley Act represented a major revision of financial services law.\textsuperscript{380} This act removed the prohibition against the conduct of commercial lending and investment banking activities within the same financial enterprise, a prohibition imposed by the

\textsuperscript{370} Id. § 26.
\textsuperscript{372} Id. § 2.
\textsuperscript{373} Id. §§ 21–43.
\textsuperscript{374} 12 U.S.C. §§ 1811, 1815.
\textsuperscript{375} 12 U.S.C.A. § 1819.
\textsuperscript{376} 12 U.S.C. § 1812(a) (1).
\textsuperscript{377} 12 U.S.C.A. § 1812(b) (1).
\textsuperscript{378} Federal Credit Union Act, id. §§ 1751–1759k (2004).
\textsuperscript{379} Id. §§ 1462–70.
Glass-Steagall Act following the Great Depression.\textsuperscript{381} In addition, the act made the Federal Reserve the umbrella regulator for financial holding companies, a new designation for complex financial services organizations.\textsuperscript{382}

The IMF has not yet conducted an FSAP assessment of the United States. However, the U.S. Department of the Treasury conducted a self-assessment of U.S. compliance with the Core Principles in 1998.\textsuperscript{383} The self-assessment concluded that the United States generally complies with the Core Principles.\textsuperscript{384} The bank regulatory agencies are independent and have sufficient staff resources and funding.\textsuperscript{385} The supervisors have the authority to issue licenses and sufficient enforcement authority, from issuing fines to ordering the closure of banks.\textsuperscript{386} The various regulatory agencies have issued appropriate regulations on capital adequacy and loan exposure.\textsuperscript{387}

The only weakness highlighted in the self-assessment was the lack of mandatory “know-your-customer” rules to discourage the use of the banking system for money laundering or criminal activity.\textsuperscript{388} Since the issuance of the self-assessment, the U.S. Department of the Treasury has issued regulations requiring banks to institute a Customer Identification Program.\textsuperscript{389} These regulations meet the requirement of “know-your-customer-rules” set forth in Principle 15 of the Core Principles.\textsuperscript{390}

Overall, the United States is compliant with the Core Principles. According to its own self-assessment, it has fully implemented the Core Principles.\textsuperscript{391} Furthermore, an independent observer has

\textsuperscript{384} \textit{See generally U.S. Dep’t of the Treasury, supra note 383} (finding that the United States, for the most part, follows the Core Principles).
\textsuperscript{385} Id. at 3.
\textsuperscript{386} Id. at 10–12.
\textsuperscript{387} See id. at 16–19.
\textsuperscript{388} Id. at 35.
\textsuperscript{389} 31 C.F.R. § 103 (2004).
\textsuperscript{390} \textit{Core Principles, supra note 15, at 6.}
\textsuperscript{391} \textit{See supra note 384 and accompanying text.}
ranked the United States first in the world for compliance with international financial standards, including the Core Principles.\footnote{EStandards Forum Weekly Report, supra note 296, at 11.}

\section*{F. Emerging Markets}

Implementation of the Core Principles by emerging markets has been more problematic. Generally, the industrialized nations and, in particular, those represented on the Basel Committee, comply with the Core Principles. As seen by recent bank failures, however, this does not mean that the financial systems of the industrialized nations are not risk-free.\footnote{See, e.g., Joseph J. Norton & Christopher D. Olive, The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory—Market Partnership, 16 ANN. REV. BANKING L. 227, 240–41 (1997) (noting the failures of the Barings Bank and the New York branch of Daiwa Bank).} According to one source, nearly 70\% of nations do not adhere to the principle of consolidated supervision in regulating banks, and approximately 45\% do not have an independent bank regulator.\footnote{Agustin Carstens, Deputy Managing Director, IMF, Opportunity for Emerging and Developing Countries in International Standard Setting: An IMF Perspective, Address Before the Fourth Annual IMF/World Bank/Federal Reserve Seminar (June 2, 2004), available at http://www.imf.org/external/np/speeches/2004/060204a.htm.} Offshore financial centers have been of particular concern. In fact, the IMF, in conducting the FSAP, has given priority to assessing forty-four offshore financial centers.\footnote{See generally IMF, Offshore Financial Centers: The Assessment Program—An Update (2004) (discussing the assessment of the offshore financial centers), available at http://www.imf.org.} As of March 2004, the IMF has completed its assessment of forty-two of these forty-four.\footnote{Id. at 6.} Compliance with international financial standards among these offshore financial centers tended to increase with income per capita.\footnote{Id. at 7.} According to the IMF, about 40\% of the offshore financial centers need to strengthen the bank supervisors’ independence, the supervisors’ available resources, and their ability to conduct onsite and offsite examinations of banks.\footnote{Id. at 8.}

\section*{III. Enforcement of the Core Principles}

As discussed above, the Core Principles, like nearly all international financial standards, are “soft law.”\footnote{Soft law means “[g]uidelines, policy declarations, or codes of conduct that set standards of conduct but are not legally binding.” Black’s Law Dictionary 1397 (8th ed.} They are not treaties en-
forceable under international law. The members of the Basel Committee did not intend to create a treaty and did not negotiate the Core Principles as a treaty.

Developing international financial standards as soft law has some advantages. This type of law is flexible and allows the parties to consider specific national conditions or attributes in implementing the standards. For instance, the Core Principles are sensitive to the fact that bank regulatory structures differ greatly among nations. The United Kingdom has a single regulator—the Financial Services Authority—for the entire financial sector. The United States has several bank regulators at the federal level—the Federal Reserve, the Comptroller of the Currency, and the FDIC—and numerous bank regulators at the state level. The Core Principles do not require a specific regulatory structure for compliance. They allow nations to maintain their current structure as long as certain underlying principles, such as independence of the regulator, adequate funding, and adequate staffing, are met. As a practical matter, requiring a specific regulatory structure would be virtually impossible because the reorganization of regulatory agencies typically requires legislation that likely is not within the power of bank regulators alone.

Another advantage that non-binding standards provide is the relative ease with which countries reach agreement on them. The nations recognize the non-binding nature of the agreement and thus tend to be more inclined to accept their substantive standards.

Finally, soft law is particularly effective in industries characterized by rapid change, such as the financial services sector, where improvements in technology and communications allow for new financial products and new methods of delivering financial services.

Nevertheless, soft law also has its disadvantages. This type of law is not directly enforceable by a court or any other judicial authority or tribunal. No court or other legal authority would use the standard as a basis for legal action because the parties never intended to enter into an enforceable agreement.

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400 See supra notes 278–296 and accompanying text.

401 See supra notes 364–392 and accompanying text.


403 Id. at 3.

404 See Ho, supra note 248, at 648 n.2.
Furthermore, because the agreements are not legally enforceable, nations can vary in their own interpretation and implementation of the standards. No central authority mandates a particular interpretation; therefore, nations can implement the standards with greater flexibility. For example, the recently announced Revised Capital Accord is intended to apply only to internationally active banks, yet the Basel Committee has never specifically defined what constitutes an “internationally active bank.” The United States has stated that the provisions of the Revised Capital Accord will only apply to internationally active banks (probably the largest thirty or so banks in the United States). In contrast, the EU is planning to enact a directive that requires all banks within the EU to meet the capital requirements under the Revised Capital Accord. Thus, the EU and the United States have interpreted the applicability of the Revised Capital Accord in divergent manners.

Traditionally, the Basel Committee has relied on peer pressure among its members to enforce its standards, including the Core Principles. Bank regulators that freely agree to standards and fail to implement them will likely suffer a loss of reputation within the Committee. Given the Basel Committee’s constant activity reviewing financial supervisory practices around the world, a failure to implement a standard in good faith would likely weaken a nation’s position with respect to future negotiations on new or revised standards.

A. Financial Sector Assessment Program

The IMF and the World Bank have taken on the role of assessing nations’ compliance with international financial standards. The IMF has identified twelve key standards, one of which is the Core

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405 Revised Capital Accord, supra note 48, at 1.
Principles, as benchmarks of its assessment program.\textsuperscript{410} In the late 1990s, the IMF organized an assessment program that focused solely on a nation’s implementation of these standards.\textsuperscript{411} The IMF and the World Bank typically send a team of experienced bank supervisors to a nation to evaluate the nation’s compliance with these standards. The IMF then issues its findings from this inspection in documents entitled Reports on Standards and Codes (“ROSC”).\textsuperscript{412}

Subsequently, in 1999, with the cooperation of the World Bank, the IMF expanded and strengthened the ROSC program by creating the FSAP.\textsuperscript{413} The FSAP takes a broader assessment of the overall financial stability and soundness of a nation’s financial system and reviews the nation’s fiscal and monetary policies.\textsuperscript{414} A component of this assessment is a review of the implementation of the twelve key standards,\textsuperscript{415} and, in determining the level of compliance with these standards, the FSAP team compares both the letter of the law and actual practice.\textsuperscript{416}

The IMF publishes the FSAP reports and the ROSC on a particular country only if that country agrees to publication.\textsuperscript{417} Publication of these reports is needed to increase transparency of bank regulatory systems and improve market discipline. Unfortunately, countries do not always consent. In the report on the forty-two offshore financial centers, only twenty-two of the jurisdictions had consented to publication of the FSAP report as of April 2004.\textsuperscript{418}

In 2003, the IMF Board considered instituting a policy of publishing all FSAP reports but decided to maintain its current policy of publishing these reports only with the permission of the nation as-

\begin{flushright}
410 IMF, \textit{supra} note 285.
412 IMF ROSC Reports, \textit{supra} note 411; see Weber, \textit{supra} note 17.
414 Id.
415 See IMF, \textit{supra} note 285.
417 IMF, \textit{supra} note 409, at 29.
\end{flushright}
Nevertheless, the IMF did agree to publish the annual Article IV surveillance reports of each member nation beginning July 1, 2004. Article IV surveillance refers to reviews of member nations’ foreign exchange policies, as required by Article IV of the IMF Articles of Agreement. In recent years, these surveillance reports have expanded into an overall review of the monetary policy, fiscal policy, and financial services sector of a particular nation. In the past, the IMF only published the Article IV reports with the permission of the nation assessed.

Publication of the FSAP reports and the ROSCs improves the transparency of national regulatory practices and the soundness of national financial systems. The IMF and World Bank encourage publication of these reports, as do other standard-setting bodies, such as the Financial Stability Forum. A refusal to agree to the publication of the report by the assessed country may indicate serious non-compliance with the standards. Presumably, a jurisdiction complying with the Core Principles and other standards, or making good progress in compliance with the standards, would want to advertise that fact.

Credit rating agencies, such as Fitch Ratings and Standard and Poor’s, review the publicly available reports on compliance with standards when determining a country’s sovereign rating. Compliance with international financial standards is a positive factor in rating a nation’s ability to repay its debt. A better credit rating typically reduces the interest rate that a country must pay on its sovereign debt. This reduction in the interest rate and, thus, borrowing costs, provides an incentive for nations to comply with standards and to agree to publish the independent assessment of the IMF.

420 Id.
422 Fin. Stability Forum, supra note 419, at 29.
425 See Chambers, supra note 245; Fox, supra note 245.
426 Fox, supra note 245.
For example, emerging market countries’ compliance with these standards is linked to higher credit ratings and lower spreads. After examining data on ratings and spreads from twenty-nine countries, researchers at the IMF concluded:

Our findings suggest that improved adherence to standards, and the higher ratings that result, could help a country mitigate the impact of an external crisis by supporting continued access to external borrowing. Adherence can help prevent crises by reducing spreads and helping the authorities remain solvent in cases it otherwise might not have remained solvent.

Other IMF reports likewise confirm that compliance with international financial standards improves sovereign credit ratings and decreases borrowing costs.

B. Revised Capital Accord

The Revised Capital Accord provides another opportunity to enforce the Core Principles. Pillar I of the Revised Capital Accord defines methods for calculating the minimum required capital for banks. Under the standardized method described in Pillar I, banks may use the ratings by external credit assessment agencies to calculate risk weights for sovereign debt and for debt owed by corporations and banks. The higher the sovereign rating, the lower the risk weight and the lower the amount of capital allocated to that particular credit. The credit rating agencies consider compliance with international financial standards, including the Core Principles, in deter-

428 See id.
430 Revised Capital Accord, supra note 48, at 12-14.
431 Id. at 23–26.
432 See id. at 12–14.
mining ratings. Rating agencies review and evaluate ROSCs and FSAP reports, among other sources of information, in determining sovereign ratings. By complying with international financial standards, national governments make their debt, and loans to corporate borrowers in that nation, more attractive to international banks, because those banks can allocate less capital to those loans and, therefore, increase their profit margins on the loans.

The standardized method also allows banks to consider export credit insurance ratings in determining risk weights. Export credit insurance provides coverage in the event that a nation prevents payments for exports. The insurance premium is dependent on many factors, one of which is the stability of the nation’s financial and political system. In calculating insurance premiums, export credit insurance agencies consider a nation’s compliance with international financial standards, including the Core Principles, and will review any available ROSCs or FSAP reports.

Thus, the provisions of the Revised Capital Accord provide an incentive for nations to implement the Core Principles. Full implementation of the Core Principles will lower borrowing costs for countries, and the borrowers located therein, and reduce the export credit insurance premiums that exporters will pay for coverage. Banks and international businesses therefore have an incentive to exert political pressure on governments to comply with these international financial standards in order to reduce these costs of doing business. International banks and businesses will focus their operations on countries that have complied with international financial standards in order to lower their interest payments on loans and export credit insurance premiums, respectively.

One weakness of reliance on sovereign ratings, however, is that rating agencies do not necessarily analyze all nations. Fitch Ratings issued sovereign ratings for approximately ninety countries in 2004.

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434 Chambers, supra note 245.
435 Revised Capital Accord, supra note 48, at 15-16.
438 See id. at 22–24.
Moody’s and Standard and Poor’s analyzed approximately 100 countries each. The IMF currently has 184 member nations. Thus, approximately seventy jurisdictions are not currently rated by one of these three major credit rating agencies. The largest and most important countries are rated (sometimes by all three agencies), but some less developed nations are not rated and therefore will be unable to take advantage of the lower risk weight categories. The Revised Capital Accord places loans to non-rated countries in the 100% risk weight category. Nevertheless, credit rating agencies will likely expand their coverage in the near future, so unrated nations obviously have an incentive to encourage agencies to evaluate them for a rating.

The second pillar of the Revised Capital Accord focuses on the prudential supervision of a bank’s risk management methods. Pillar II refers to the Core Principles as part of the overall supervisory process, and states that the Revised Capital Accord complements “the extensive supervisory guidance” in the Core Principles and the Methodology. In other words, a review of capital adequacy is not a stand-alone process, but is part of the overall supervision of banks. Bank supervisors should apply other supervisory guidance issued by the Basel Committee in addition to the minimum capital adequacy levels of the Revised Capital Accord.

C. IMF and World Bank Loan Conditions

Conditionality of loans by the IMF and the World Bank provides another enforcement mechanism for the Core Principles. After

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442 The author analyzed the country lists of the four credit rating agencies: Standard and Poor’s, Moody’s, Fitch Ratings, and Capital Intelligence, a ratings agency based in Cyprus with its website at http://www.ciratings.com (last visited May 4, 2005).

443 Revised Capital Accord, supra note 48, at 15.

444 See Vojta & Adams, supra note 433, at 26. EStandards Forum is planning to increase its monitoring and ratings to included 180 countries. Id.


447 See Revised Capital Accord, supra note 48, at 174.

IV. Next Steps

The enforcement capabilities of the Core Principles have improved since the 1980s. While enforcement of the Core Principles does not approach the level of enforcement available with binding international treaties, significant improvements in enforcement mechanisms have been made.

What are the next steps in international bank regulation and supervisory cooperation? As the chart in Appendix A and the discussion above show, the history of the Basel Committee standards indicates that standards are developed and then improved in incremental steps. The Basel Committee has typically reacted to bank and financial crises by amending and improving international standards. It has not issued standards in a proactive attempt to anticipate weaknesses in the international financial system.

This reactive approach to standard setting has resulted in standards that are increasingly detailed in their language, while at the same time increasingly broad in their scope. The Basel Committee...
initially issued standards related only to the cooperation of supervisors in cross-border banking. Since the Concordat, however, the standards have become steadily more detailed. Then, at the urging of the G-7, the Basel Committee issued broad standards for the entire bank supervisory system, not just for the international coordination of bank supervision, with the Core Principles in 1997.

With regard to capital adequacy, the Basel Committee issued the original Capital Accord in 1988. This accord set substantive minimum capital levels, marking the first time that bank regulators had ever agreed on such a standard. The Revised Capital Accord, issued in June 2004, further develops and revises these standards on minimum capital adequacy.

Given the Basel Committee’s history, incremental change and improvement to the standards will likely continue to be the trend in the development of international bank regulation. Nations tend to be cautious about regulating their financial sectors because of the importance of financial institutions to national economies, especially in emerging markets. Agreeing to an international standard potentially means a loss of national sovereignty, something to which nations are generally very reluctant to concede. Nevertheless, broader and more detailed international standards will be the norm, if for no other reason than improved technology will further increase trade in financial services, pushing nations to revise and expand international financial standards in order to improve the stability of an increasingly global financial system.

Is an international treaty on banking regulation likely in the next decade? While the possibility cannot be ruled out, agreement on a treaty is unlikely in the near future.452 The international financial system changes quickly as new products are introduced and new markets develop. Treaties are viewed as too rigid to accommodate these rapid changes.453 In addition, in the event of a financial crisis, bank supervisors desire flexibility to craft a solution to the crisis and fear that a treaty may unexpectedly and unduly restrict their responsiveness.454


Nevertheless, a treaty does have numerous enforcement mechanisms that are not available with voluntary international standards.

In 1998, Tony Blair, the Prime Minister of Great Britain, proposed a new international body to improve stability in the international financial system.455 This agency would combine the responsibilities of the Bank for International Settlements, the IMF, and the World Bank.456 The idea went nowhere. No supranational body regulating the international financial system is likely in the near future because of nations’ concerns regarding a loss of sovereignty.457 The EU, in implementing its Financial Services Action Plan and the Lamfalussy Process, is approaching the creation of a supranational regulator of financial services. Even there, member states and the European Parliament are setting limits on the extent of convergence.458 Under the EU’s founding documents, the member states have transferred their sovereign power in certain areas to the EU, but not the prudential supervision of banks and credit institutions.459

Many commentators applaud the establishment of the Financial Stability Forum and expect it to become more prominent in the financial regulatory arena.460 The goal of the Financial Stability Forum is to coordinate the international regulation of the banking, insurance, and securities sectors as financial institutions frequently provide all three types of services.461 Regulators are often organized along sectoral lines and therefore do not easily cooperate in the supervision of complex financial institutions that operate in all three lines of business. As these institutions increasingly offer all types of financial services in such an integrated manner, sectoral supervision is beginning to make less sense. The consolidated supervision of these complex financial institutions becomes more difficult and can place excessive regulatory costs on financial institutions that have to prepare and file multiple reports with several different regulatory agencies.

456 Id.
458 See Randzio-Plath, supra note 264, at 10.
459 EC Treaty, supra note 249, art. 105(5)–(6).
Emerging markets, such as India, China, and certain Latin American countries, will likely continue to become more involved in the Basel Committee process. Emerging market countries made a significant contribution to the Basel Committee’s Core Principles\textsuperscript{462} and have continued to contribute to Basel Committee activities. The central banks from certain emerging markets, such as China and India, joined the Bank for International Settlements in 1996.\textsuperscript{463} As emerging markets become more important in the international financial system, their involvement and influence in the Basel process will undoubtedly grow. In 1948, the developed nations (North America, Western Europe, and Japan) accounted for 58.8% of merchandise world trade, while emerging markets accounted for 6.9% of merchandise world trade.\textsuperscript{464} In 2002, the developed nations’ percentage of world trade was 64.1%, while the emerging markets’ percentage had increased to 9.5%.\textsuperscript{465} In 1985, banks located in the G-7 nations accounted for 79.5% of all outstanding loans in the world. In 2003, the G-7 banks accounted for 61.5%—an 18% decrease.\textsuperscript{466} Although the G-7 banks predominate international lending, other banks, including those from emerging markets, are gaining market share. Over the long run, emerging markets will very likely increase their share of international lending and world trade, gaining commensurate influence in the Basel Committee process. As stakeholders in this process, emerging markets will thus be more likely to implement the Core Principles and other international financial standards on a consistent basis.

**Conclusion**

The Core Principles have generally been a success in the developed world. They represent a logical evolution and expansion of the Basel Committee’s activities in light of the globalization of world financial markets. The Basel Committee has involved regulators from the emerging markets more extensively in the past decade, but the Core Principles have thus far not been implemented as consistently in

\textsuperscript{462} Core Principles, supra note 15, at 1–2.


\textsuperscript{465} Id.

emerging markets. Soft law is currently the principal approach to har-
monize bank regulation and supervisory practices (at least outside of
the EU). The surveillance of international financial standards compli-
ance by the IMF and the World Bank represents a new enforcement
 technique for the Core Principles and other key international financial
 standards. The Revised Capital Accord itself reinforces the enforce-
 ment of the Core Principles. The world undoubtedly will experience
 additional financial crises in the future. The cooperation and trust
 among bank supervisors engendered by the process of negotiating the
 Core Principles, the Revised Capital Accord, and other international
 banking standards will increase the likelihood of an effective resolution
 of any future financial crisis.
## Appendix A

### Basel Committee on Banking Supervision

#### Historical Development of Major Supervisory Standards

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