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Introductory Note to the Basle Committee Paper on Proposals for International Convergence of Capital Measurement and Capital Standards

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Introductory Note
by
Cynthia C. Lichtenstein

In 1986, I.L.M. published a prior paper prepared by the Bank for International Settlements' Committee on Banking Regulations and Supervisory Practices (often called the "Cooke Committee" after its Chairman, Peter Cooke of the Bank of England, or, sometimes, the Basle Supervisors' Committee) on Management of Banks' Off-Balance-Sheet Exposures [25 I.L.M. 978 (1986)]. As the Introductory Note to that paper explained, that paper represented a waystone in the search by the banking supervisors of the major industrialized countries for a means to coordinate prudential supervision over banking organizations in their international activities. The Basle Supervisors' Committee had studied the nature of the risks involved in the new practices in international banking that had evolved since 1985 and the paper was issued, according to the Committee, "to encourage" a coordinated response to the new developments. "Encouragement" to harmonized action, however, was all that was intended; as the Committee noted, the paper was not "intended to be prescriptive." Exactly how national authorities might go about gaining coordinated prudential control over the multinational banks subject to their jurisdiction was not spelled out. Essentially, the 1986 paper was only a sign post that national authorities could choose to follow, if so motivated.

The difficulty, of course, with leaving the actual prudential standard setting strictly up to individual national authorities is that, as has been well pointed out by Richard Dale in his recent book, national authorities have conflicting interests. The industrialized nations have a common interest in ensuring the soundness of the entities, the multinational banks, that provide the international payments system. At the same time, each nation has an interest in furthering the profitability of its multinational banks as against those banks' competitors, the banks of the other nations, an interest that can lead, in Dale's term, to "an inbuilt tendency towards competitive deregulation."
United States regulatory authorities had issued proposed regulations imposing supplemental capital requirements that were calibrated to risk and included requirements for off-balance-sheet exposures along with lines suggested by the Basle Supervisors' Committee's 1986 paper. The comments from the affected banks on the proposed regulations, of course, pointed out the extent to which United States banking organizations would be hampered in competition with foreign banks, were foreign banks to be free from such capital requirements.

The response of the United States regulators to this plaint was the announcement in January, 1987 of a risk-adjusted capital proposal that had been worked out jointly by the Federal Reserve, the United States central bank, and the Bank of England, the United Kingdom's central bank. The proposal, as released for public comment in a news release dated January 8, 1987 was entitled "Agreed Proposal of the United States Federal Banking Supervisory Authorities and the Bank of England on Primary Capital and Capital Adequacy Assessment." The title itself is significant. The two central banks, in the main, had made common accord as to the capital base that would be required of banks subject to each country's jurisdiction including the required capital to support off-balance-sheet business and merchant banking activities. Equally important, however, was the hope of the U.K. and the U.S. supervisory authorities that their agreement would "provide a reasonable basis for working with other countries to achieve a more consistent international framework for assessing capital adequacy."

In short, the U.S. and the U.K. regulators accepted the difficulties of actual implementation of the new standards unless the supervisory authorities of Japan and the rest of Western Europe, the home bases of the chief market competition for U.K. and U.S. multinational banks, could be persuaded to go along. While the U.S. banking authorities promulgated proposed regulations to implement the U.S./U.K. proposal, most likely to permit the industry to comment and to acclimate the banks affected to the new notion that the regulatory ideology of central banks of other nations might have an impact on United States banking regulation, the agencies deferred final action on the U.S/U.K. Agreed Proposal until more countries joined the party.

Throughout the period of issuance of the U.S./U.K. Agreed Proposal, the Cooke Committee had continued to meet in Basle, and presumably, continued to try to hammer out the technical details of a proposal which would result in reduction, at least in so far as capital requirements for international banking are concerned, of competitive inequality arising from differences in supervisory requirements among nations. The following document (significantly, referred to as the "Basle Agreement" in the Federal Reserve Board staff memorandum forwarding to the Federal Reserve Board the proposed interagency Federal Register Notice putting out the U.S. capital adequacy regulations proposed to implement the internationally agreed to standards) represents a quite extraordinary achievement of those experts on the Cooke Committee and their principals, the central banks of twelve nations, that have agreed, in the interest of the stability and soundness of the international financial system, to burden equally with a common standard of
capital adequacy the banks under their jurisdiction. In less than two years, the central banks of twelve industrialized nations have moved from a stance of encouraging coordination in capital requirements "in the light of the legal and other institutional circumstances" 10/ of each sovereign to an agreed upon, highly articulated, with precisely delineated minority views, framework for common standards. This "Basle Agreement" provides national supervisory authorities with some discretion in implementation, but the basic harmonization is one that leaves no room for competitive laxity in capital requirements.

There follows after the BIS' Consultative Paper the Bank of England's Explanatory Paper for U.K. banks of how it intends to implement the framework, and exercise the limited discretion authorized it by the Agreement.

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2/ Ibid., page 172.

