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Abstract

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NOTES

THE PROPOSED RISK-BASED CAPITAL FRAMEWORK: A MODEL OF INTERNATIONAL BANKING COOPERATION?

INTRODUCTION

The rapid internationalization of banking over the past two decades has resulted in extensive interdependency among the world's banks.[1] Supervision by national authorities over domestic banks no longer provides an adequate framework for regulating bank operations.[2] On December 10, 1987, the Basle Committee on Banking Regulations and Supervisory Practices[3] ("Basle Committee" or "Committee") of the Bank for International Settlements ("BIS") in Basle, Switzerland,[4] announced a preliminary agreement by central bank governors of twelve industrialized nations for a proposed risk-based capital framework ("Proposal").[5] The Proposal seeks to set minimum

1. Hackney & Shafer, *The Regulation of International Banking: An Assessment of International Institutions*, 11 N.C. J. INT'L L. & COM. REG. 475, 475 (1986).

2. *Id.*

3. The Basle Committee consists of representatives of central bank supervisory authorities from Switzerland, Luxembourg, and the Group of Ten countries, which are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. Comptroller of the Currency, Fed. Deposit Ins. Corp. & Fed. Reserve Bd., Joint News Release, at 1 (Dec. 10, 1987) [hereinafter Joint News Release] (available at *Fordham International Law Journal* office).

4. The Bank for International Settlements was established in 1930 and is located in Basle, Switzerland. Hackney & Shafer, *supra* note 1, at 486. BIS is both an international financial institution and a forum for discussion of common issues. *Id.* at 487. It was established "to promote cooperation among central banks, to provide additional facilities for financial operations, and to act as trustee for post-World War I reparations agreements." *Id.* at 486.

5. Bank for Int'l Settlements, Proposal for International Convergence of Capital Measurement and Capital Standards, Committee on Banking Regulations and Supervisory Practices Consultative Paper 1 n.1 (1987) [hereinafter BIS Proposal], *reprinted in* 27 I.L.M. 530 (1988). The proposal will affect all banks that undertake significant cross-border business and are regulated by supervisory authorities who are members of the Basle Committee. *Id.* at 1-4, *reprinted in* 27 I.L.M. at 530-33; Spencer & Murray-Jones, *Capital Adequacy: Towards a Level Playing Field*, INT'L FIN. L. REV., Mar. 1988, at 19 [hereinafter Spencer & Murray-Jones, *Capital Adequacy*]. For example, in the United States, banks regulated by the Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") will be affected. Joint News Re-

levels of capital in relation to the risks that banks undertake.[6] The proposal is seen as a significant first step toward achieving international banking supervisory cooperation in measuring capital.[7]

This Note argues that although the proposal for a risk-based capital framework is a positive move toward facilitating international cooperation on bank supervisory matters, it may encounter a number of difficulties in implementation. Part I examines the recent internationalization and growing interdependency of the world's banks as well as the role that the Basle Committee plays in fostering international cooperation. Part II examines the proposed agreement for a risk-based capital framework. Part III analyzes the difficulties that may arise in the Proposal's implementation. This Note concludes that despite the lack of an enforcement mechanism, the Proposal will in all likelihood achieve its purposes because it stands as a true model of international banking cooperation.

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lease, *supra* note 3, at 2. The FRB has jurisdiction over bank members of the Federal Reserve System, *see* Federal Reserve Act, 12 U.S.C.A. §§ 241-250 (West 1945 & Supp. 1988), and bank holding companies, *see* Bank Holding Company Act of 1956, 12 U.S.C.A. §§ 1841-1850 (West 1980 & Supp. 1988). The OCC supervises national banks. *See* National Bank Act, 12 U.S.C.A. §§ 21-42 (West 1945 & Supp. 1988). The FDIC has authority over insured state banks. *See* Federal Deposit Insurance Act, 12 U.S.C.A. §§ 1811-1832 (West 1980 & Supp. 1988). For an overview of the regulatory structure of the United States banking industry, see 1 M. MALLOY, THE CORPORATE LAW OF BANKS 28-52 (1988).

On January 25, 1988, the OCC, FRB, and FDIC issued a notice specifying in great detail how the United States bank regulators plan on applying the proposal to United States banks, whether or not internationally active. Spencer & Murray-Jones, *Capital Adequacy*, *supra*, at 23; *see* Risk-Based Capital; Notice of Proposed Guidelines, 53 Fed. Reg. 8550 (Dep't Treas., Fed. Reserve Sys. & Fed. Deposit Ins. Corp. 1988).

6. BIS Proposal, *supra* note 5, at 3, *reprinted in* 27 I.L.M. at 532.

7. *New Banking Standards Unveiled*, DUN'S BUS. MONTH, Feb. 1987, at 27, col. 2. The proposal is similar to the agreement between the United States and the United Kingdom issued on January 8, 1987, for a proposal on primary capital and capital adequacy assessment. Spencer & Murray-Jones, *Capital Adequacy*, *supra* note 5, at 19; *see also* Murray-Jones & Spencer, *The US/UK Proposal on Capital Adequacy* (pts. 1 & 2), INT'L FIN. L. REV., Aug. 1987, at 20, INT'L FIN. L. REV., Sept. 1987, at 27 (for an overview of the United States' and the United Kingdom's proposed agreement). The Basle Proposal is more significant because it includes 12 industrialized nations rather than just two. *See* BIS Proposal, *supra* note 5, at 1, *reprinted in* 27 I.L.M. at 530. In the words of Federal Reserve Board chairman Paul Volcker the agreement is "a breakthrough . . . a step toward international consistency." Yang, *US & Britain Propose a Rule on Bank Capital*, Wall St. J., Jan. 9, 1987, at 3, col. 4.

I. *THE GLOBALIZATION OF BANKING AND THE BASLE COMMITTEE*

The dramatic expansion of international banking in the past two decades has left international regulation and supervision far behind.[8] Domestic banking authorities are unable to supervise their banks' international activities adequately because of significant differences in foreign regulatory policies.[9] However, great strides have been achieved by the Basle Committee in encouraging supervisory cooperation and in developing greater uniformity in banking standards.[10]

A. *The Internationalization of Banking*

International banking is now a major component of overall banking activity in many countries.[11] Because of increased trade and capital flow among nations,[12] there has been a growing tendency for banks to transact business through their foreign branch offices.[13] Banks have recognized the strategic advantage of providing their clients with easy access to international markets.[14] In addition, banks have considered it necessary to establish themselves abroad to protect their competitive position in the face of the expansion of Eurocurrency markets.[15] International banks have also become intermediaries between oil-exporting and oil-importing countries because of a series of oil crises in the late 1970s.[16]

Unfortunately, supervision of domestic banks has not kept

8. Hackney & Shafer, *supra* note 1, at 475.

9. R. PECCHIOLI, THE INTERNATIONALISATION OF BANKING: THE POLICY ISSUES 67 (1983); Lamfalussy, *Worldwide Competition in Financial Markets: Issues for Banking Supervisors*, ISSUES BANK REG., Winter 1987, at 15, 22.

10. Cooke, *Overview of International Supervisory Issues*, ISSUES BANK REG., Summer 1984, at 3, 5 [hereinafter Cooke, *Overview*].

11. R. PECCHIOLI, *supra* note 9, at 51.

12. R. DALE, THE REGULATION OF INTERNATIONAL BANKING 2 (1986); R. PECCHIOLI, *supra* note 9, at 16.

13. R. DALE, *supra* note 12, at 2; R. PECCHIOLI, *supra* note 9, at 51.

14. R. PECCHIOLI, *supra* note 9, at 52.

15. R. DALE, *supra* note 12, at 2; R. PECCHIOLI, *supra* note 9, at 52. Eurocurrency markets are markets in which currencies are deposited outside the country of issue. R. DALE, *supra* note 12, at 2. This creates new opportunities in terms of new customers and borrowers. R. PECCHIOLI, *supra* note 9, at 52.

16. R. DALE, *supra* note 12, at 2. As a result of the ongoing oil crisis, oil-exporting and oil-importing countries experienced balance of payments instability. *Id.*

pace with the rapid growth in international banking.[17] The failure of various national banking supervisory systems to keep up with the recent growth is evidenced by the rash of bank failures during the 1970s in the United States and in Europe[18] and the global debt crisis that emerged in 1982.[19] National supervisory authorities have increasingly been confronted with problems arising from complex international banking structures and from differences in foreign regulatory policies.[20] The differences in regulatory policies have created advantages for some banking nations and disadvantages for others.[21] National supervisory authorities have been reluctant to modify their regulations for fear that any change will impair their banks' competitive advantage.[22]

Because of the interdependency of the international banking system, the difficulties experienced by one domestic bank can affect other members of the banking community and weaken the entire system.[23] The stability of the world's banking system and the creation of a level playing field where banks may compete equally in the international arena have emerged as major policy issues among banking authorities.[24]

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17. Friesen, *The Regulation and Supervision of International Lending: Part I*, 19 INT'L LAW. 1059, 1063-64 (1985) [hereinafter Friesen, *Part I*]; Hackney & Shafer, *supra* note 1, at 475.

18. Friesen, *Part I*, *supra* 17, at 1060-64; R. DALE, *supra* note 12, at 2, 156-67.

19. Note, *New Controls on Global Debt: The International Lending Supervision Act of 1983*, 17 CORNELL INT'L L.J. 425 (1984). In 1974, Germany's largest private bank, I.D. Herstatt, failed, and two large state banks, Hessische Landesbank Girozentrale and Westdeutsche Landesbank Girozentrale, suffered severe losses from foreign exchange dealings. J. BAKER, INTERNATIONAL BANK REGULATION 15-16 (1978). In addition, Italy's Banca Privata and several secondary banks in the United Kingdom failed. *Id.* In Switzerland, where banking has been considered very stable, the Lugano office of Lloyds Bank International suffered large foreign exchange losses in 1974. *Id.* In the United States in 1974, the Franklin National Bank failed as a result of overextension of foreign exchange trading. *Id.*

20. R. PECCHIOLI, *supra* note 9, at 67.

21. *Measuring the Foreign-Exchange Value of the Dollar*, 73 Fed. Res. Bull., 411, 435, 436 (1987) [hereinafter *Measuring Foreign-Exchange*].

22. *Id.*

23. R. PECCHIOLI, *supra* note 9, at 104.

24. R. DALE, *supra* note 12, at 2; Monroe-Davies, *Capital Ratios Are Only One Step*, BANKER, May 1987, at 55; Yang, *supra* note 7.

B. *The Basle Committee*

The Basle Committee[25] is made up of bank supervisors from the so-called Group of Ten nations as well as Luxembourg and Switzerland.[26] It was established in 1974 by the Bank for International Settlements,[27] an organization of thirty central banks.[28]

The Basle Committee has three primary objectives.[29] First, it aims to provide a forum where supervisory authorities may meet to develop closer personal communication and mutual cooperation.[30] Second, it seeks to formulate guidelines for the supervision of banks' foreign offices and activities, thereby eliminating significant gaps in international supervisory arrangements.[31] Finally, the Committee attempts to ex-

25. For background on the Basle Committee, see Cooke, *Basle Supervisors' Committee*, ISSUES BANK REG., Summer 1984, at 7 [hereinafter Cooke, *Basle Supervisors' Committee*]. The Committee is also known as the Cooke Committee after its chairman, W. Peter Cooke. Hackney & Shafer, *supra* note 1, at 488.

26. Cooke, *Basle Supervisors' Committee*, *supra* note 25, at 7; Hackney & Shafer, *supra* note 1, at 488.

27. Hackney & Shafer, *supra* note 1, at 488.

28. Members include Albania, Australia, Austria, Belgium, Bulgaria, Canada, Czechoslovakia, Denmark, Finland, France, Greece, Hungary, Iceland, Ireland, Italy, Japan, the Netherlands, Norway, Poland, Portugal, Romania, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States, West Germany, and Yugoslavia. 1 UNION OF INT'L ASS'NS, YEARBOOK OF INTERNATIONAL ORGANIZATIONS F0184g (22d ed. 1985).

29. GEN. ACCOUNTING OFFICE, INTERNATIONAL COORDINATION OF BANK SUPERVISION: THE RECORD TO DATE 2, 15 (Feb. 1986) [hereinafter INTERNATIONAL COORDINATION OF BANK SUPERVISION]; Cooke, *Basle Supervisors' Committee*, *supra* note 25, at 8; Cooke, *Supervising Multinational Banking Organization: Evolving Techniques for Cooperation Among Supervisory Authorities*, 3 J. COMP. CORP. L. & SEC. REG. 244, 245 (1981) [hereinafter Cooke, *Supervising Multinational Banking*].

30. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 2, 15; Cooke, *Basle Supervisors' Committee*, *supra* note 25, at 8; Cooke, *Supervising Multinational Banking*, *supra* note 29, at 245.

31. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 2, 15; Cooke, *Supervising Multinational Banking*, *supra* note 29, at 245. The Basle Committee's first achievement in improving cooperative supervision of international banking was its Concordat in 1975. Committee on Banking Regulations and Supervisory Practices, *The New Concordat—Principles for the Supervision of Banks' Foreign Establishments*, ISSUES BANK REG., Summer 1984, at 25 [hereinafter *The New Concordat*]. The Concordat set out broad guidelines delineating responsibilities among national supervisory authorities for the supervision of banks operating in more than one jurisdiction. *Id.*

The Concordat provides that:

(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

amine risks that arise from international banking.[32] The Basle Committee seeks to maintain a delicate balance between preserving national interests and freedom of the international marketplace.[33]

Agreements are reached only by a consensus of the mem-

> country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities.
>
> (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 authority should take account of the exposure of their domestic banks' foreign subsidiaries and joint ventures because of the parent banks' moral commitment in this regard.
>
> (5) Practical cooperation would be facilitated by transfers of information between host and parent authorities and by 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 co-operation.

Cooke, *Developments in Co-operation Among Banking Supervisory Authorities*, 3 J. COMP. CORP. L. & SEC. REG. 253, 256 (1981).

The Concordat was revised in 1983 to clarify certain issues. *The New Concordat*, *supra*, at 26. The revised Concordat does not contradict the guidelines set out in the original Concordat. *Id.* The revised Concordat recommends "best practices" for the division of responsibilities between parent and host authorities in the supervision of foreign bank establishments. *Id.* There are three main differences in the revised edition:

> First, . . . the revised Concordat incorporates the principle of consolidated supervision as an important technique of supervision to enable parent authorities to monitor the overall risk exposure and capital adequacy of banking groups. Adoption of this principle does not, however, imply any lessening of host authorities' responsibilities and the revised Concordat recognises that the responsibilities of host and parent authorities should to some extent overlap each other. Second, . . . [it] reiterat[es] the objective of the original document that no international banking operation should escape effective supervision, [and] addresses further ways in which any supervisory gaps can be prevented . . . . Third, [it] makes explicit what was implicit in the earlier paper—it addresses questions of supervisory responsibility and not those of lender of last resort.

Id.

The revised Concordat has been endorsed by the Basle Committee member countries and is currently being implemented. Bench & Sable, *International Lending Supervision*, 11 N.C. J. INT'L L. & COM. REG. 427, 431 (1981).

32. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 2, 15; Cooke, *Basle Supervisors' Committee*, *supra* note 25, at 8.

33. Cooke, *Supervising Multinational Banking*, *supra* note 29, at 245.

ber nations and attempt to take into consideration the diverse nature of each member's laws and regulatory practices.[34] The Committee has no direct power to implement any changes in national laws.[35] Thus, although each member nation commits itself in good faith to follow the Committee's guidelines, each is still free to do as it chooses.[36] It is up to the member nations themselves to effect any changes in their national laws or regulations.[37]

For several years the Basle Committee has been working toward the goal of formulating an agreement for a more stringent capital framework.[38] Committee members believe that banks operating internationally should strengthen their capital practices and that, above all, capital should not be allowed to deteriorate further than it has in recent years.[39]

II. *THE PROPOSED RISK-BASED CAPITAL FRAMEWORK*

The Basle Committee's Proposal for international convergence of capital measurement and capital standards was prompted by growing concern among supervisors worldwide about the declining levels of capital held by banks.[40] The Proposal has two objectives.[41] First, it aims to strengthen the stability of the international banking system by fortifying the capital resources that banks are required to maintain.[42] Second, it seeks to remove competitive inequalities that arise from differences in national supervisory requirements.[43] Specifically, the Proposal includes a uniform definition of capital,[44] a risk-based

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34. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 16.
35. *Id.*
36. *Id.*
37. *Id.*
38. BIS Proposal, *supra* note 5, at 1, *reprinted in* 27 I.L.M. at 530; Holland, *Foreign Bank Capital and the United States Federal Reserve Board,* 20 INT'L LAW. 785, 812-14 (1986).
39. Bench & Sable, *supra* note 31, at 431.
40. Cooke, *Overview*, *supra* note 10, at 5.
41. Joint News Release, *supra* note 3, at 2; *Measuring Foreign-Exchange*, *supra* note 21, at 437.
42. Joint News Release, *supra* note 3, at 2; *Measuring Foreign-Exchange*, *supra* note 21, at 437.
43. Joint News Release, *supra* note 3, at 2; *Measuring Foreign-Exchange*, *supra* note 21, at 437.
44. BIS Proposal, *supra* note 3, at 4-10, annex 1, *reprinted in* 27 I.L.M. at 533-38, 550-54.

capital ratio,[45] and a common minimum standard ratio.[46]

A. *Uniform Definition of Capital*

Capital is the financial cushion that banks maintain to absorb unforeseen losses in times of economic stress.[47] A capital adequacy standard is the minimum level of capital that banks are required to maintain to ensure the stability and solvency of banking practices.[48] It is expressed as a percentage of assets.[49]

The Proposal establishes a uniform definition of capital, referred to as adjusted primary capital,[50] because different nations have varying definitions of what constitutes capital and different methods to account for capital.[51] The calculation of adjusted primary capital includes four factors:[52] Tier 1 (Core Capital),[53] Tier 2 (Supplementary Capital),[54] goodwill,[55] and

45. *Id.* at 10-18, annex 2-3, *reprinted in* 27 I.L.M. at 538-46, 554-60.

46. *Id.* at 18-19, *reprinted in* 27 I.L.M. at 546-47.

47. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 25; R. DALE, *supra* note 12, at 182; Nash, *12 Countries Want Banks To Increase Capital*, N.Y. Times, Dec. 11, 1987, at A3, col. 3.

48. Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected*, 7 ANN. REV. BANKING L. 75, 75 n.1 (1988) [hereinafter Malloy, *U.S. International Banking*].

49. Malloy, *U.S. International Banking*, *supra* note 48, at 75 n.1.

50. The risk-based capital ratio is to be calculated as follows: "Adjusted Primary Capital [divided] by Risk-weighted assets and off-balance-sheet items [plus] Allowance for loan and lease losses (exclusive of reserves for identified losses, such as allocated transfer risk reserves) [minus] Appropriate adjustments." Proposed Risk-Based Capital Framework, 52 Fed. Reg. 5119, 5133 (Fed. Reserve Sys. 1987).

51. Cooke, *Overview*, *supra* note 10, at 5. *See generally* Friesen, *The Regulation and Supervision of International Lending: Part II*, 20 INT'L LAW. 153 (1986) [hereinafter Friesen, *Part II*]; Friesen, *Part I*, *supra* note 17, at 1059. Friesen examines in detail regulatory and supervisory banking systems of the United States, the United Kingdom, the Federal Republic of Germany, Japan, France, Belgium, the Netherlands, and Switzerland.

52. BIS Proposal, *supra* note 5, annex 1, *reprinted in* 27 I.L.M. at 550-54.

53. *Id.* Tier 1 consists of core capital, which is equity capital and published reserves from post-tax retained earnings. *Id.* Because of the soundness of Tier 1 capital, Tier 1 elements must make up at least 50% of adjusted primary capital. *Id.* at 4-5, *reprinted in* 27 I.L.M. at 533-34.

54. *Id.* at 5-10, *reprinted in* 27 I.L.M. at 534-37. Tier 2 is limited to supplementary capital up to a total amount equal to that of Tier 1 elements. *Id.* annex 1, at 1, *reprinted in* 27 I.L.M. at 550. The supplementary capital elements are undisclosed reserves, asset revaluation reserves, general provisions/general loan-loss reserves, hybrid debt/equity capital instruments, and subordinated term debt. *Id.* annex 1, *reprinted in* 27 I.L.M. at 550-54. Subordinated term debt will be limited to a maximum of 50% of Tier 1 elements. *Id.* Hidden reserves may be included but are subject to a 55% discount on the difference between the historic cost book value and market

certain investments in other financial institutions.[56] The equation used to calculate adjusted primary capital is:

[(Tier 1 − goodwill) + Tier 2] − (certain investments in other financial institutions).[57]

Adjusted primary capital is the numerator in the calculation of the risk-based capital ratio.[58] The denominator of the risk-based capital ratio—the weighted risk-asset base[59]—measures the relative riskiness of different categories of a bank's assets.[60]

B. *Risk-Based Capital Ratio*

The risk-based capital ratio aims to quantify and account for financial factors that may significantly affect a bank's level of capital adequacy, including those factors that are not apparent on a bank's balance sheet ("off-balance sheet items").[61] Broadly speaking, the ratio measures weighted risk against ad-

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value. *Id.* at 6, *reprinted in* 27 I.L.M. at 534-35. This reflects concerns about market volatility and tax charges that would arise when such gains are realized. *Id.*

In additon, the Basle Committee realizes that it is not always possible to distinguish clearly between general loan-loss reserves that are generally freely available and those that are earmarked for identified losses. *Id.* at 7, *reprinted in* 27 I.L.M. at 535-36. This uncertainty results from the present diversity of accounting, supervisory, and fiscal policies with respect to provisioning and to the national definitions of capital. *Id.* Therefore, inevitably, there will be differences in the characteristics of general provisions/general loan-loss reserves maintained by each countries' banks. *Id.* In light of these uncertainties, the Basle Committee plans to develop proposals to ensure consistency in the definition of general loan-loss reserves by 1990. *Id.*

55. Goodwill is an "intangible asset that represents the difference between the book value of a business and its purchase (or sale) price when the latter is greater than the book value; an asset representing the value of the proprietorship of a business in excess of the amount of proprietorship appearing on the books, the amount by which the price that a corporation pays for the assets of a business exceeds the proprietary interest of the owners." L. DAVIDS, DICTIONARY OF BANKING AND FINANCE 105 (1978).

56. BIS Proposal, *supra* note 5, annex 1, at 2, *reprinted in* 27 I.L.M. at 551. These investments include investments in unconsolidated banking and financial subsidiary companies and investments in the capital of banks and financial institutions. *Id.*

57. *Id.*

58. *See supra* note 50.

59. Malloy, *U.S. International Banking*, *supra* note 48, at 89.

60. BIS Proposal, *supra* note 5, at 10, *reprinted in* 27 I.L.M. at 538-39; *Measuring Foreign-Exchange*, *supra* note 21, at 437.

61. *See infra* note 65 and accompanying text. "The principal impact of the proposal will generally fall on large banking institutions and those with significant off-balance sheet exposures." Risk-Based Capital; Notice of Proposed Guidelines, 53 Fed. Reg. 8550, 8563 (Dep't Treas., Fed. Reserve Sys. & Fed. Deposit Ins. Corp. 1988).

justed primary capital.[62] The weighted risk is the denominator of the risk-based capital ratio.[63] It consists of on-balance[64] and on-balance sheet credit risk equivalents (converted off-balance sheet items),[65] to which allowances for loan and lease losses[66] are added, and from which so-called "appropriate adjustments"[67] are deducted.[68] The calculation of the weighted risk-asset base (denominator) is:

> [(On-balance sheet item × risk weight) + ((off-balance sheet item × credit risk conversion factor) × risk weight)] + (allowances for loan and lease losses) − (appropriate adjustments).[69]

Off-balance sheet items are weighted according to risks through a two-step process.[70] First, they are converted into credit risk equivalents by multiplying principal amounts by a credit-risk conversion factor.[71] Off-balance sheet instruments

62. BIS Proposal, *supra* note 5, at 10, *reprinted in* 27 I.L.M. at 538.

63. Malloy, *U.S. International Banking*, *supra* note 48, at 89; *see supra* note 50.

64. BIS Proposal, *supra* note 5, at 10, *reprinted in* 27 I.L.M. at 538. On-balance sheet items include, generally, assets, loans, and claims. *Id.* annex 2, *reprinted in* 27 I.L.M. at 554-55.

65. *Id.* at 10, *reprinted in* 27 I.L.M. at 538. Off-balance sheet items do not show up on a bank's balance sheet. Editorial, *International Banking—Off-Balance Sheet Exposures of Banks*, 1986 J. Bus. L. 178. The growth of off-balance sheet activities has caused national concern because it is not accounted for on a balance sheet. *Id.* The risk off-balance sheet activities carry are in principle no different from those associated with on-balance sheet activities and can weaken a bank's soundness just as easily as risks associated with on-balance sheet activities. *Id.* Off-balance sheet items include guarantees, floating-rate notes, swaps, letters of credit, and such. BIS Proposal, *supra* note 5, annex 3, *reprinted in* 27 I.L.M. at 555-60.

66. General loan-loss and lease reserves are created to protect against the possibility of future losses. BIS Proposal, *supra* note 5, at 6-7, *reprinted in* 27 I.L.M. at 535-36. These will not include reserves that have been already set aside for identified losses, as these reserves will not be freely available. *Id.*

67. Adjustments may be made by supervisory authorities if their final supervisory judgment of a bank's capital adequacy significantly differs from the results drawn from the calculation of the risk-based ratio. Murray-Jones & Spencer, *The US/UK Proposal on Capital Adequacy (pt. 1)*, *supra* note 7, at 23.

68. *See supra* note 50.

69. BIS Proposal, *supra* note 5, annex 2, at 1, *reprinted in* 27 I.L.M. at 550-54; *see also supra* note 50.

70. BIS Proposal, *supra* note 5, at 17-18, annex 3, *reprinted in* 27 I.L.M. at 545-46, 555-60.

71. *Id.*; *see also* Risk-Based Capital; Notice of Proposed Guidelines, 53 Fed. Reg. 8550, 8567 (Dep't Treas., Fed. Reserve Sys. & Fed. Deposit Ins. Corp. 1988) (for a sample calculation of credit-risk equivalents).

are divided into five broad categories according to credit risk.[72] The category determines which credit-risk conversion factor is to be applied.[73] Second, the on-balance sheet credit-risk

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72. BIS Proposal, *supra* note 5, annex 3, *reprinted in* 27 I.L.M. at 555-60. The framework primarily measures credit risk in the capital assessment. *Id.* at 3, *reprinted in* 27 I.L.M. at 532. However, the Basle Committee believes that other risks such as interest rate risk and investment risk should also be taken into account by supervisors in capital adequacy assessment. *Id.* The Committee is presently examining ways to incorporate these risks into the framework. *Id.* The United States federal banking authorities have emphasized that complete compliance with the risk-based capital framework might not be sufficient to determine a bank's relative strength and that other factors will also be reviewed. Spencer & Murray-Jones, *Capital Adequacy*, *supra* note 5, at 21. These factors include

> the composition and diversification of the loan portfolio, the level and severity of problem and classified assets, the quality, trend and variability of earnings, the dividend payout ratio, and the level and trend of retained earnings, liquidity and the structure of liabilities, the effectiveness of loan and investment policies, and management's overall ability to monitor and control risks.

Id.

73. BIS Proposal, *supra* note 5, at 17-18, *reprinted in* 27 I.L.M. at 545-46. The off-balance-sheet items are divided into five broad categories:

(1) Direct credit substitutes that substitute for loans. *Id.* at 17, *reprinted in* 27 I.L.M. at 545. These items will have a 100% credit risk conversion factor. *Id.* For example, "general guarantees of indebtedness, bank acceptance guarantees and standby letters of credit serving as financial guarantees for loans and securities." *Id.*

(2) Trade-related contingencies will carry a 50% credit risk conversion factor. *Id.* For example, "performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions." *Id.*

(3) Short-term, self-liquidating trade-related contingent liabilities arising from the movement of goods will have a 20% credit risk conversion factor. *Id.* at 17-18, *reprinted in* 27 I.L.M. at 545-46. For example, documentary credits collateralized by the underlying shipments. *Id.*

(4) Commitments with a long-term original maturity, and all revolving underwriting facilities and note issuance facilities, will have a 50% credit risk conversion factor. *Id.* at 18, *reprinted in* 27 I.L.M. at 545-46. Under a revolving underwriting facility an agent purchases Euronotes at an amount requested by the issuer. *Id.* "A Euronote is a short-term promissory note typically issued in the Eurodollar market in bearer form." Logan, Mahoney, Slade & White, *The Securitization of U.S. Bank Activities in the Eurodollar Market—Issues for U.S. Counsel*, 11 N.C.J. INT'L L. & COM. REG. 539, 543 (1985). Under a note issuance facility, "an uncommitted tender panel of financial institutions competitively bids to purchase Euronotes in an aggregate face amount requested by the issuer, which results in the lowest possible interest expense to the issuer." *Id.* Shorter-term commitments or commitments that can be cancelled at any time that generally carry only low risks will carry a zero weight. BIS Proposal, *supra* note 5, at 18, *reprinted in* 27 I.L.M. at 546. This is justified on de minimis grounds. *Id.*

(5) Interest and foreign-exchange rate-related items, such as swaps, options, and futures, are given special treatment because banks are not exposed to credit risk for the full face value of their contracts. *Id.* at 18, annex 3, *reprinted in* 27

equivalents are assigned a risk-weight also according to the degree of credit risk of the obligor.[74] The Proposal establishes five broad categories of risk weights: 0%, 10%, 20%, 50%, and 100%.[75] The greater the risk of the asset, the higher the risk weight assigned.[76] On-balance sheet items go through a one-step process[77] that is identical to the second step of the off-balance sheet process.[78] The Proposal grants supervisory authorities flexibility in determining the appropriate category within which assets, both on-balance and off-balance sheet,

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I.L.M. at 546, 555-60. Banks risk only the potential cost of replacing cash flow if the counterparty defaults. *Id.* The credit equivalent amounts will depend on the maturity of the instrument and on the volatility of the rates underlying the instrument. The amounts will be calculated in one of two ways, it being understood that banks would not be permitted to switch between the two. *Id.* annex 3, at 5 n.3, *reprinted in* 27 I.L.M. at 559 n.3. The "current exposure initial" calculates the current replacement cost by marking to market and adding on a factor to represent the potential exposure during the remaining life of the contract. *Id.* annex 3, at 3-5, *reprinted in* 27 I.L.M. at 557-59. Because of the complexity of this approach, an alternative formula is the "original exposure method," where the conversion factor is based on the nominal principal sum of each contract according to its type and maturity. *Id.* annex 3, at 5-6, *reprinted in* 27 I.L.M. at 559-60.

74. *Id.* at 17, annex 3, *reprinted in* 27 I.L.M. at 545, 555-60; Spencer & Murray-Jones, *Capital Adequacy*, *supra* note 4, at 23.

75. BIS Proposal, *supra* note 5, at 17, annex 3, *reprinted in* 27 I.L.M. at 545, 555-60. The risk weight of 0% will be applied to cash, balances and claims on domestic central banks, loans to domestic central governments, securities issued by domestic central governments, and loans and other amounts fully collateralized by cash or domestic central government securities or that are fully guaranteed by domestic central governments. *Id.* annex 2, *reprinted in* 27 I.L.M. at 554-55. The risk weight of 0% or 20% will be applied to claims on International Bank Reconstruction and Development and regional development banks at national discretion. *Id.* European Community countries will treat their European institutions consistently. *Id.* Twenty percent will be applied to claims on domestic and foreign banks with short-term original maturity, claims on domestic banks with long-term original maturity and loans guaranteed by domestic banks, claims on foreign central governments in local currency financed by local currency liabilities, and cash items. *Id.* Zero, twenty, or fifty percent will be applied to claims on the domestic public sector, not including central government at national discretion and loans guaranteed by such institutions. *Id.* Fifty percent will be applied to loans to residential house purchase owner-occupiers that are fully secured by mortgages. *Id.* One hundred percent will be applied to claims on the private sector, cross-border claims on foreign banks with a long-term original maturity, claims on foreign central governments (unless the 20% was applied), claims on commercial companies, premises, plants, and equipment and other fixed assets, real estate and other investments owned by the public sector, capital instruments issued by other banks (unless deducted from capital), and all other assets. *Id.*

76. *Id.* annex 2-3, *reprinted in* 27 I.L.M. at 554-60.

77. *Id.* at 10, *reprinted in* 27 I.L.M. at 539.

78. *Id.* at 10, annex 3, at 1, *reprinted in* 27 I.L.M. at 538-39, 555.

fall.[79] Given the broad categories set out for both risk weights and off-balance sheet items, supervisory authorities will face uncertainties in determining which category an item falls into.[80]

The result of dividing adjusted primary capital (the numerator) by the weighted risk-asset base (the denominator) is the so-called risk-based capital ratio,[81] which is used to measure the adequacy of a bank's capital structure.[82]

C. *Common Minimum Capital Requirement*

The purpose of calculating the risk-asset capital ratio is to determine the minimum level of capital that a bank must maintain to guard against unforeseen losses.[83] This minimum amount, which is expressed as a percentage of assets, is referred to as capital adequacy.[84] A sufficient level of capital adequacy also helps to create public confidence in a bank.[85]

The Basle Committee has tentatively set the ultimate minimum target of capital adequacy at 8%.[86] However, two member countries, West Germany and France, prefer to consult with their banks without being bound to a numerical standard.[87] Banks would be given five years from the date of the Proposal's agreement, that is, until 1992, to make any necessary adjustments to implement the Proposal.[88] National authorities would also be free to adopt higher levels or more stringent supplementary arrangements to measure capital.[89]

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79. *Id.* at 10, *reprinted in* 27 I.L.M. at 539; Joint News Release, *supra* note 3, at 1.

80. BIS Proposal, *supra* note 5, at 3, *reprinted in* 27 I.L.M. at 532.

81. BIS Proposal, *supra* note 5, at 10-18, *reprinted in* 27 I.L.M. at 538-46; Friesen, *Comparative Bank Capital Guidelines*, 3 REV. FIN. SERVICES REG. 113, 117 (1987) [hereinafter Friesen, *Comparative Bank*]; *see also* Risk-Based Capital; Notice of Proposed Guidelines, 53 Fed. Reg. 8550, 8565 (Dep't Treas., Fed. Reserve Sys. & Fed. Deposit Ins. Corp. 1988) (for a sample calculation of the Risk-Based Capital Ratio); *supra* note 50.

82. BIS Proposal, *supra* note 5, at 10, *reprinted in* 27 I.L.M. at 538.

83. *Id.* at 1, *reprinted in* 27 I.L.M. at 530.

84. Malloy, *U.S. International Banking*, *supra* note 48, at 75 n.1.

85. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 25.

86. BIS Proposal, *supra* note 5, at 18-19, *reprinted in* 27 I.L.M. at 546-47. A higher specific ratio may be set by United States regulators for any particular bank. Spencer & Murray-Jones, *Capital Adequacy*, *supra* note 5, at 23.

87. Norman, *Ways to Boost Global Banking Stability Proposed by 12 Industrialized Nations*, Wall St. J., Dec. 11, 1987, at 10, col. 1.

88. BIS Proposal, *supra* note 5, at 20, *reprinted in* 27 I.L.M. at 547-48.

89. *Id.* at 3, *reprinted in* 27 I.L.M. at 532.

Overall, the proposed risk-based capital framework has three primary objectives.[90] First, it provides an equitable and consistent basis for making international capital comparison among different banking systems.[91] Second, it takes into account both on-balance sheet and off-balance sheet risk exposures in assessing capital adequacy.[92] Third, it avoids deterring banks from holding liquid or low-risk assets.[93]

III. *THE PROPOSAL: A TRUE MODEL OF BANKING COOPERATION?*

The Proposal for a risk-based capital framework is considered a landmark in international regulatory agreement.[94] It is significant because it addresses an area of great concern among national supervisors.[95] It also makes progress toward international consistency and supervisory cooperation while minimizing global competitive distortions.[96]

The Basle Committee recognizes that significant differences exist among countries in bank accounting and supervisory practices.[97] The proposed framework has provided national authorities with some flexibility in implementing the risk-based capital measure.[98] However, this flexibility does not by itself eliminate the difficulties and obstacles that may arise in implementation.

Banks of different countries are accustomed to different types of supervision, ranging from a strict rule-based system to an informal consultation system.[99] Obtaining compliance with

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90. Joint News Release, *supra* note 3, at 2.

91. *Id.*

92. *Id.*

93. *Id.*

94. Nash, *Capital Plan Is Based on Risks Involved in Bank Assets*, N.Y. Times, Feb. 1, 1988, at D8, col. 3 [hereinafter Nash, *Capital Plan*].

95. *See supra* notes 23-24 and accompanying text. Capital adequacy is a critical factor in ensuring the safety and soundness of every banking system. R. DALE, *supra* note 12, at 57-60.

96. BIS Proposal, *supra* note 5, at 1, *reprinted in* 27 I.L.M. at 530; Yang, *supra* note 7.

97. BIS Proposal, *supra* note 5, at 3-4, *reprinted in* 27 I.L.M. at 532; Friesen, *Comparative Bank*, *supra* note 81, at 113; *Measuring Foreign-Exchange*, *supra* note 21, at 439.

98. BIS Proposal, *supra* note 5, at 3-4, *reprinted in* 27 I.L.M. at 532; Joint News Release, *supra* note 3, at 1.

99. J. BAKER, *supra* note 19, at 19. For example, United States bank supervision

the Proposal may thus be difficult.[100] Moreover, two of the twelve members involved, West Germany and France, have not agreed to set a common minimum target capital standard.[101] The other ten have agreed on 8% as the minimum capital ratio to be achieved.[102]

The Proposal sets out broad categories for both the risk weights[103] and the credit-risk conversion factors[104] to provide national authorities with discretion in implementing the framework.[105] However, the advantages of providing this flexibility will lead banks to undertake excess risks. Indeed, although the Proposal sets out to discourage banks from undertaking unnecessarily high risks,[106] it may instead encourage banks to take on higher credit and interest-rate risks.[107] For example, banks need to set aside less capital for loans to a domestic government because domestic government borrowings have far lower capital requirements (0% risk weight) than loans to private borrowers (100% risk weight).[108] And, because banks view capital as a very expensive source of funds, they may be encouraged to put more money in a high-risk, high-yielding government instrument issued, for example, by a nearly insolvent town in the United States, than in a loan to a triple A, or blue-chip, corporation.[109] In addition, because high-quality loans have low returns on equity, banks may be motivated to make high-credit loans or loans with high interest-rate risk to obtain greater returns on equity.[110]

Furthermore, because banks of different member nations

is highly rule-based and the United Kingdom's bank supervision is based on frequent consultation and cooperation. Friesen, *Part I*, *supra* note 17, at 1068-97.

100. Friesen, *Comparative Bank*, *supra* note 81, at 121.

101. BIS Proposal, *supra* note 5, at 19, annex 3, *reprinted in* 27 I.L.M. at 548, 555-60; Norman, *supra* note 87, at 10, col. 1.

102. BIS Proposal, *supra* note 5, at 2, 18-19, *reprinted in* 27 I.L.M. at 531, 546-47.

103. *Id.* annex 2, *reprinted in* 27 I.L.M. at 554-55.

104. *Id.* annex 3, *reprinted in* 27 I.L.M. at 555-60.

105. Joint News Release, *supra* note 3, at 1. The Proposal seeks to discourage banks from undertaking high risks by requiring banks to put aside more capital for higher risk activities than low risk activities. *See* BIS Proposal, *supra* note 5, annex 2, 3, *reprinted in* 27 I.L.M. at 554-60.

106. Joint News Release, *supra* note 3, at 2.

107. Bryan, *Capital Guidelines Could Weaken Banks*, Wall St. J., April 23, 1987, at 32, col. 3.

108. BIS Proposal, *supra* note 5, annex 2, *reprinted in* 27 I.L.M. at 554-55.

109. Bryan, *supra* note 107, at 32, col. 3.

110. *Id.*

at present determine capital differently, different burdens may arise in the implementation of a uniform capital standard. For example, some member nations' banks, particularly British, West German, and Swiss banks, may find it fairly easy to meet the proposed minimum capital requirement, while other member nations' banks, including United States and Japanese banks, may find it difficult.[111] For instance, the Proposal allows hidden reserves to be included in the calculation of capital subject to a discount of 55%.[112] Hidden reserves are the unearned appreciation of assets.[113] They are determined by calculating the difference between book value and market value of assets.[114] Since hidden reserves are not considered capital by West Germany's current banking regulations,[115] West German banks will find it easier to meet the minimum level of capital required.[116] In contrast, Japanese banks will find it harder to raise capital because the Proposal applies a 55% discount to their use of hidden reserves.[117] Japanese banking regulation currently allows Japanese banks to include up to 70% of hidden reserves in the calculation of capital.[118]

Key United States bankers are concerned by the Proposal because they feel that it will adversely affect their competitive position. For one thing, goodwill, which is routinely included in current calculations of capital adequacy, is excluded by the Proposal.[119] For another, some United States banks may have to raise additional capital to meet the minimum capital ratio of

111. *Bank Regulation Levelling*, ECONOMIST, Dec. 12-18, 1987, at 92.

112. BIS Proposal, *supra* note 5, annex 1, at 2, *reprinted in* 27 I.L.M. at 551.

113. Friesen, *Part I*, *supra* note 17, at 1102 n.215. Hidden reserves are undisclosed reserves representing "accumulated after-tax retained earnings that are not disclosed on the balance sheet of a bank." Risk-Based Capital; Notice of Proposed Guidelines, 53 Fed. Reg. 8550, 8554 (Dep't Treas., Fed. Reserve Sys. & Fed. Deposit Ins. Corp. 1988).

114. *See* L. DAVID, *supra* note 55, at 109.

115. Friesen, *Part I*, *supra* note 17, at 1102 n.215.

116. Norman, *Seventeen Industrial Nations Draft Pact on Big Banks' Capital-Adequacy Needs*, Wall St. J., Oct. 23, 1987, at 23, col. 2.

117. *Id.*

118. Semkow, *The Deregulation of Japan's Financial Markets*, INT'L FIN. L. REV., Aug. 1987, at 39. As a Federal official commented, " '[t]he Japanese were pretty heavily hair-cutted' by the agreement." Taylor, *New Capital Rules Affect Some Banks, Fed. Official Says*, Wall St. J., Dec. 30, 1987, at 2, col. 5.

119. *See* BIS Proposal, *supra* note 5, annex 1, at 2, *reprinted in* 27 I.L.M. at 551. The United States' top 10 banks have almost US$4 billion in goodwill that will no longer be counted as capital after 1992. Nash, *Capital Plan*, *supra* note 94.

8%, and thus may assume riskier obligations to compensate for the lower profits generated by the higher capital requirements.[120] The Proposal might also restrict banks' ability to enter into bank mergers because banks would be required to maintain and reserve larger pools of capital.[121] Finally, because the Proposal applies only to banks, banks may be placed at a competitive disadvantage with investment houses.[122]

The Basle Committee recognizes that its Proposal cannot be completely effective unless it is communicated to supervisory banking agencies in non-member countries.[123] Because only twelve countries have agreed to the proposed framework,[124] its effect is limited.[125] Competitive distortions cannot be totally eliminated if only twelve countries in the world participate in the Proposal's implementation.[126] In addition, the stability of the international banking system may be weakened by the less stringent capital requirements of non-member countries.[127]

Despite these concerns, the Basle Committee's Proposal is significant because it provides a forum for cooperation and for improving the guidelines within the Proposal.[128] In fact, the Proposal itself provides for assessments of each member nation's progress in meeting the proposed capital standards during the transitional period set by the Committee.[129] The Committee will take account of differences in each member nation's banking policies and procedures in consultations for future

120. Nash, *Plan Could Stall Banking Mergers*, N.Y. Times, Feb. 8, 1988, at A1, col. 1, at D8, col. 3.

121. *Id.*

122. Berg, *Fed Acts on Banks' Swap Risk*, N.Y. Times, March 5, 1987, at D1, col. 6., at D6, col. 4.

123. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 28.

124. Joint News Release, *supra* note 3, at 1.

125. *See* Cooke, *Overview*, *supra* note 10, at 4. Some jurisdictions, such as Hong Kong, "do not formally regulate capital adequacy, while others make an essentially judgemental assessment." R. DALE, *supra* note 12, at 91; Lamfalussy, *supra* note 9, at 22.

126. Malloy, *U.S. International Banking*, *supra* note 48, at 80.

127. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 34; Monroe-Davis, *supra* note 24, at 55. As one commentator stated, "It may eventually be ground into the dust by an unholy combination of national interest and national and international bureaucracy." Monroe-Davis, *supra* note 24, at 55.

128. Cooke, *Basle Supervisors' Committee*, *supra* note 25, at 8; Cooke, *Supervising Multinational Banking*, *supra* note 29, at 245.

129. BIS Proposal, *supra* note 5, at 2-3, *reprinted in* 27 I.L.M. at 531-32.

provisions.[130] This consideration itself may eliminate many of the problems that exist within the Proposal.

The Basle Committee is also currently undergoing discussions with the European Economic Community ("EEC" or "Community")[131] with the goal of agreeing on a common approach to be applied to EEC banks.[132] The Committee also has contact with many other non-member countries.[133] For instance, several Committee members are also members of other regional banking groups.[134] Committee members also attend

130. *Id.* In fact, as three United States administrative agencies have noted, the Basle Committee

> does not mandate a completely uniform structure to be employed by all countries. Rather, the framework attempts to recognize and accommodate, within prescribed limits, unique features of individual countries arising from differences in basic accounting procedures, in the structure and evolution of banking and financial markets, and in fundamental supervisory methodologies and techniques. While not eliminating these differences, the Basle capital framework nonetheless represents a significant step toward the adoption of more consistent international procedures for measuring and evaluating capital adequacy in relation to a broadly-accepted international norm.

Risk-Based Capital; Notice of Proposed Guidelines, 53 Fed. Reg. 8550, 8551-52 (Dep't Treas., Fed. Reserve Sys. & Fed. Deposit Ins. Corp. 1988).

131. The Member States of the EEC are Belgium, France, Germany, Italy, Luxembourg, the Netherlands, the United Kingdom, Denmark, Greece, Ireland, Portugal, and Spain. Treaty Between the Member States of the European Communities and the Kingdom of Spain and the Portuguese Republic Concerning the Accession of the Kingdom of Spain and the Portuguese Republic to the European Economic Community and to the European Atomic Energy Community, O.J. L 302/9 (1985). Of the 12 Member States, the first seven are also members of the Basle Committee. BIS Proposal, *supra* note 5, at 2, *reprinted in* 27 I.L.M. at 531.

132. BIS Proposal, *supra* note 5, at 2, *reprinted in* 27 I.L.M. at 531. "The Basle Proposal concentrates on banks undertaking significant international business, while the European Commission's proposal would apply to banks in the EC." Spencer & Murray-Jones, *Capital Adequacy*, *supra* note 5, at 20-21.

133. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 28.

134. *Id.* For example, all the member countries of the Basle Committee are also members of the Expert Group on Banking of the Organization for Economic Cooperation and Development ("OECD"). *See* R. PECCHIOLI, *supra* note 9, at 7; *see also supra* note 3 (for a list of the member countries of the Basle Committee). This group consists of bank regulatory and supervisory officials from industrialized countries. Hackney & Shafer, *supra* note 1, at 495. They are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. R. PECCHIOLI, *supra* note 9, at 7. The OECD has also prepared studies on differing national supervisory requirements and areas for convergence of requirements. Hackney & Shafer, *supra* note 1, at 495.

Japan is a member of the SEANZA (South-East Asia, New Zealand, and Australia) Forum of Bank Supervisors. *Id.* at 495-96. Forum members include Australia, Bangladesh, India, Indonesia, Iran, Japan, Korea, Malaysia, Nepal, New Zealand, other regional banking group meetings.[135] Furthermore, reports of other regional banking groups' activities are included in Committee annual reports.[136] In addition, discussions of the Committee's activities are held at periodic international conferences of bank supervisors.[137] Finally, the Committee is also circulating the Proposal to the supervisory authorities of non-member nations with the hope of encouraging a world-wide standard of capital adequacy.[138]

A. *A Legal Framework: Is It Necessary?*

The Basle Proposal is essentially a "gentlemen's agreement." It creates nothing more than an expectation of and a reliance on compliance by all the member nations.[139] It does not create any enforceable rights or duties. It merely establishes a set of guidelines that the members of the Basle Committee may follow if they so choose.[140] The Proposal's dependence on cooperation as opposed to coercion may be both its best and worst feature. Because there are no legal mechanisms to enforce compliance, member nations may be encouraged to resolve problems through negotiation and cooperation. The

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Pakistan, Singapore, Sri Lanka, and Thailand. *Id.* at 495-96. Non-members of the Indian sub-continent, South-East Asia, and the Pacific Basin may also attend meetings. *Id.* The Forum's purposes are to encourage cooperation in the exchange of information and ideas and to discuss problems of common interest. *Id.* at 496.

135. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 28. For example, members attend the meetings of the the OECD, SEANZA Forum of Bank Supervisors, the Nordic Supervisory Group (which includes Denmark, Finland, Norway, Sweden, and Iceland) and the Commission of Banking Supervisory and Regulatory Administration Authorities of Latin America and the Caribbean. *Id.* at 28-32.

136. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 28.

137. *Id.* The Committee has sponsored three international conferences: in London in 1979, in Washington in 1981, and in Rome in 1984. *Id.*; Cooke, *Developments in Co-operation Among Banking Supervisory Authorities* 253, 255-56 (1981). Representatives from nearly 100 countries attended the Rome conference. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 28. All present endorsed the revised Concordat. *Id.* at 28-29; *see also supra* note 31 (for an overview of the revised Concordat).

138. BIS Proposal, *supra* note 5, at 2, *reprinted in* 27 I.L.M. at 531.

139. Editorial, *The Twilight Existence of Non-binding International Agreements*, 71 AM. J. INT'L L. 296, 299 (1977); *see also* BIS Proposal, *supra* note 5, at 1-2, *reprinted in* 27 I.L.M. at 530-31 (setting out the framework in the form of a proposal and seeking to achieve a set of conceptually sound recommendations).

140. BIS Proposal, *supra* note 5, at 2, *reprinted in* 27 I.L.M. at 531; *see also* Lichtenstein, *Introductory Note*, 27 I.L.M. 524 (1988) (the Proposal has been endorsed by member countries as a basis for wider consultations).

lack of legal mechanisms, however, may lead member nations to skirt the Proposal's provisions if it is in their national interest to do so.[141]

The forces that encourage compliance with the Proposal are essentially non-legal. For one thing, the agreement has political and moral weight.[142] For another, member nations may comply because of what is referred to as "law habit."[143] That is, banking authorities may comply with the Proposal's guidelines to maintain their governments' credit rating or good standing, or because they do not want to disturb the existing structure of cooperation.[144] Each member nation has the duty to negotiate in good faith and no member nation will deny that it has negotiated in good faith.[145] There is, however, no legal forum to determine whether there was good faith.[146] In the absence of a legal mechanism, a member nation's refusal to comply with the proposed framework cannot be met with any compulsory measures.[147]

141. *See* Baxter, *International Law in "Her Infinite Variety"*, 29 INT'L & COMP. L. Q. 549, 551 (1980) (It is recognized that "joint statements of policy . . . will remain alive only so long as the states concerned see it to be in their mutual interest to concert their policies. One simply cannot think of 'violations' of such instruments.").

142. *See* Editorial, *supra* note 139, at 302 (It is recognized that "agreements [are] intended to have 'political and moral weight' even if legally non-binding. It would not be unreasonable . . . in the light of the significance accorded to such agreements in international relations.").

143. *See* Baxter, *supra* note 141, at 556 (It is recognized that "[t]he forces that make for compliance with such instruments are manifold but essentially non-legal.") Bureaucrats follow through force of "law habit."

144. *Id.* Indeed, the Basle Committee has been working on the problem of capital erosion since 1982. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 25. In June 1982, the Committee issued a paper on the capital adequacy of banks operating internationally to resist any "further erosion" in capital ratios. *Id.*

145. Representatives of each member country "commit themselves to work in their countries for the principles agreed to by the Committee." INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 16.

146. *See* Baxter, *supra* note 141, at 552 ("The assertion that the duty to negotiate or to conclude an agreement implies a duty to negotiate in good faith is an empty one. Unless appropriate machinery has been set up, no court or other agency can determine whether a state has or has not negotiated in good faith and what the duty to negotiate in good faith requires.").

147. *Id.* at 553-54 (It is recognized that "in the absence of institutional machinery . . . , a party's refusal to follow the exhortations or recommendations of the treaty cannot be met with any measures of compulsion.").

B. *The EEC's Formalized Approach*

The existence of binding authority, however, does not necessarily guarantee better results. In contrast to the Basle Committee's informal approach to banking coordination, the European Economic Community has a more formalized approach.[148] The Treaty of Rome, which established the EEC, provides the legal basis for the coordination of banking legislation.[149] It provides for the use of a legal instrument, directives, to help promote the harmonization of banking legislation and supervisory cooperation.[150]

The ultimate goal of the EEC's efforts is to achieve a uniform legislative and supervisory banking system throughout the Community.[151] The EEC has to date enacted two legal directives, the First Banking Coordination Directive[152] ("Coordi-

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148. Cooke, *Supervising Multinational Banking*, *supra* note 29, at 245. The Treaty of Rome envisioned the establishment of a common banking market that is to be realized through the satisfaction of two conditions. The first is through freedom of establishment and freedom to provide services. Treaty Establishing the European Economic Community, Mar. 25, 1957, arts. 52-66, 1973 Gr. Brit. T.S. No. 1 (Cmd. 5179-II), at 23-27 (official English trans.), 298 U.N.T.S. at 37-42 (unofficial English trans.) [hereinafter EEC Treaty]; Muller, *A Legal Framework For International Supervision: The EEC Model*, ISSUES BANK REG., Summer 1984, at 36. And the second is through coordination of banking legislation so that greater uniformity in banking can be achieved. EEC Treaty, *supra*, art. 57, 1973 Gr. Brit. T.S. No. 1, at 25, 298 U.N.T.S. at 40; Muller, *supra*, at 36 n.4.

149. *See supra* note 148.

150. EEC Treaty, *supra* note 148, art. 189, 1973 Gr. Brit. T.S. No. 1, at 60, 298 U.N.T.S. at 78-79. Article 189 of the Treaty provides:

> In order to carry out their task the Council and the Commission shall, in accordance with the provisions of this Treaty, make regulations, issue directives, take decisions, make recommendations or deliver opinions. A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States. A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods. A decision shall be binding in its entirety upon those to whom it is addressed. Recommendations and opinions shall have no binding force.

Id.

151. Muller, *supra* note 148, at 37. "Article 57 (in conjunction with Article 8) of the Treaty of Rome states that at the end of the transitional period (on January 1, 1970), the coordination of banking legislation must have been effectuated." *Id.*

152. First Council Directive No. 77/780, O.J. L 322/30 (1977) [hereinafter Coordination Directive]. In 1977, the Council of Ministers issued the First Banking Coordination Directive. *Id.* preamble, O.J. L 322/30, at 30. The Coordination Directive prohibits discriminatory treatment with regard to the establishment of banks and the provision of services among Member States. *Id.* Among other things, it provides for the elimination of most obstructive differences between Member State laws that ap-

nation Directive") and the First Consolidation Directive[153] ("Consolidation Directive"), in furtherance of this goal.[154] The Coordination Directive seeks to introduce uniform authorization requirements throughout the Community for comparable types of banks.[155] In addition, the Consolidation Directive prescribes the supervision of banks on a consolidated basis.[156] Unlike the Basle Committee, Member States are *required* to eliminate all legal obstacles to the exchange of information necessary for consolidation,[157] and if necessary, EEC members must adapt their national legislation to comply with

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ply to the taking up and pursuit of the business of credit institutions; it calls for the coordination of credit institutions to protect savings and to create equal conditions of competition; and it calls for cooperation between competent authorities and the Banking Advisory Committee ("Advisory Committee"). *Id.* It does not rule out other forms of cooperation between the authorities. *Id.* The Coordination Directive also specifies conditions under which banking authorization may be withdrawn or given reasons for refusal or withdrawal of authorization. *Id.* art. 8, O.J. L 322/30, at 35. In addition, a limited right of appeal is allowed. *Id.* art. 13, O.J. L 322/30, at 36-37. A measure of flexibility is allowed for because of the objective differences in the laws of Member States. *Id.* preamble, O.J. L 322/30, at 31. The Coordination Directive imposes only minimum requirements concerning minimum capital and management. *Id.* The Member States may impose more stringent requirements subject to two conditions. The requirements must be of a general nature and they must expire at the end of the 12-year transitional period. *Id.*; Muller, *supra* note 148, at 38.

153. Council Directive No. 83/350, O.J. L 193/18 (1983) [hereinafter Consolidation Directive]. This Directive requires consolidation of all majority-owned subsidiaries, including those located outside the country where the head office is located. *Id.* arts. 3(1), 4, 6(1), O.J. L 193/18, at 19-20. The Consolidation Directive has also extended the obligation of cooperation to verify information received. *Id.* art. 5(4), O.J. L 193/18, at 20. If a competent authority of one Member State wishes to verify information from another Member State, the competent authority of the other Member State must carry out the verification themselves, allow the requesting authority to carry it out, or allow an auditor or expert to carry it out. *Id.*

154. *See supra* notes 151-153 and accompanying text.

155. Coordination Directive, *supra* note 152, preamble, O.J. L 322/30, at 30-31. The Coordination Directive also sets up uniform observation ratios in order to monitor the solvency and liquidity of banks. *Id.* art. 6, O.J. L 322/30, at 34. The Member States must calculate the solvency and liquidity ratios despite its observation purpose because this will help facilitate the harmonization process. *Id.*; Muller, *supra* note 148, at 38.

In addition, the Coordination Directive calls for the close collaboration of supervisors of banks that operate outside the Member State other than where the head office is located to supply one another with information concerning the management and ownership of banks that would facilitate supervision, to examine banking conditions and to monitor liquidity and solvency. Coordination Directive, *supra* note 152, art. 7, O.J. L 322/30, at 34-35.

156. Consolidation Directive, *supra* note 153.

157. *Id.* art. 5(1), O.J. L 193/18, at 20; Muller, *supra* note 148, at 39.

the directives.[158]

Moreover, two groups,[159] including the so-called Contact Group,[160] work with the EEC Commission to achieve harmonization.[161] The Contact Group, which is much like the Basle Committee, provides an informal forum for the Member States' supervisory authorities.[162] The purpose of the Contact

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158. Consolidation Directive, *supra* note 153, art. 7(1), O.J. L 193/18, at 20.

159. The two groups are the Advisory Committee and the Contact Group. Muller, *supra* note 148, at 38.

160. Schneider, *The Contact Group of EEC Supervisory Authorities*, ISSUES BANK REG., Summer 1984, at 15. The Contact Group was formed in 1972, two years before the Basle Committee was formed. R. PECCHIOLI, *supra* note 9, at 106. The Contact Group, like the Basle Committee, is an informal group consisting of supervisory authorities from each Member State. Hackney & Shafer, *supra* note 1, at 492.

The Contact Group is made up of a chairman, who has a one year term, a permanent secretariat, and one representative from each national supervisory authority, who is usually a senior practicing supervisor and attends in that capacity. Schneider, *supra*, at 16. The Contact Group meets informally about three times a year and discussions are generally confidential. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 31. A representative of the EEC Commission also attends the meetings. Schneider, *supra*, at 17. The meetings are held without technical advisors, assistants or observers. *Id.* The Contact Group has felt that it should not become directly involved in the harmonization of Community banking legislation. *Id.* The chairman of the Contact Group also sits on the Basle Committee. *Id.* at 18. Moreover, there exists a mutual awareness of issues under discussion among the Basle Committee and the EEC. *Id.*

161. Coordination Directive, *supra* note 152, art. 11, O.J. L 322/30, at 36; Muller, *supra* note 148, at 38. The Advisory Committee was created by Article 11 of the 1977 Coordination Directive, O.J. L 322/30, at 36. The Advisory Committee is a high-level policy-making Committee that is backed by a secretariat from the EEC Commission. Hackney & Schafer, *supra* note 1, at 491. The Advisory Committee is made up of three representatives from each Member State plus the Commission. Coordination Directive, *supra* note 152, art. 11(4), O.J. L 322/30, at 36. All discussions are confidential unless otherwise decided by the Advisory Committee. *Id.* art. 11(6), O.J. L 322/30, at 36. The Advisory Committee also works closely with the Commission who then makes recommendations to the EEC Council. *Id.* art. 11(2), O.J. L 322/30, at 36; Clarotti, *The Harmonization of Legislation Relating to Credit Institutions*, 19 COMMON MKT. L. REV. 245, 264-65 (1982).

162. Schneider, *supra* note 160, at 15. The Contact Group works closely with the Commission and the Advisory Committee in supporting coordination. *Id.* at 17. The Contact Group has several functions. *Id.* at 16. It facilitates the exchange of information among supervisory authorities of the EEC Member States, including information about problems in banking that serves to warn other Member States of potential problems, thereby assisting in the resolution of those problems and information about developments in national supervisory legislation, administrative practices, and application of banking techniques that would lead Member State banks toward a better understanding of different bank systems. *Id.* at 16. It also undertakes detailed technical studies of the banking supervisory systems in the Member States. *Id.* The Contact Group often submits study reports to other banking organizations, such as the Basle Committee, the EEC Banking Advisory Committee, and to the EEC

Group is to assist the Member States' understanding of each other's supervisory systems and to facilitate cooperation in banking coordination within the EEC.[163] The supervisory authorities recognized the importance of developing practical cooperation to maintain adequate supervision in the face of the rapid pace of globalized banking.[164] Despite the EEC's legal structure, however, harmonized banking within the Community is still in its infancy.[165]

The modest accomplishments of the EEC's efforts at coordination[166] emphasize that the mere existence of a legal structure is not the sole, and may not be the ideal, means of achieving harmonization of supervisory matters. Indeed, it reveals the need for precisely the sort of mutual cooperation that the Basle Committee proposes.[167] Clearly, international cooperation among supervisory authorities is an essential ingredient in accommodating national differences and achieving worldwide coordination of national banking supervision and regulation.[168]

CONCLUSION

It is widely recognized that differences in national supervision must be taken into account in formulating prudential banking guidelines. National supervisors have stressed the im-

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Commission. INTERNATIONAL COORDINATION OF BANK SUPERVISION, *supra* note 29, at 31. Finally, the Contact Group acts as an informal link between the Commission and the Banking Advisory Committee in working towards the harmonization of the banking system. Schneider, *supra* note 160, at 17.

163. *See supra* note 162 and accompanying text.

164. Schneider, *supra* note 160, at 15. The Advisory Committee's general task is to assist the Commission in the formulation of new general policy guidelines to submit to the Council concerning future banking coordination. Coordination Directive, *supra* note 152, art. 11(2), O.J. L 322/30, at 36. The second general task of the Advisory Committee is to assist the Commission in implementing the Coordination Directive. *Id.* art. 6(4), O.J. L 322/30, at 34. The third is to carry out specific tasks specified in the Coordination Directive, such as establishing the uniform solvency and liquidity ratio. *Id.* art. 6(1), O.J. L 322/30, at 34.

165. Muller, *supra* note 148, at 37.

166. Bench & Sable, *supra* note 31, at 433. *See generally* Muller, *supra* note 148, at 37.

167. *See supra* note 160 and accompanying text.

168. R. DALE, *supra* note 12, at 171. "[T]he traditional distinction between 'formal' and 'informal' approaches to banking supervision does not seem of great relevance in practical terms. Much more important is the extent to which supervision is conducted in a flexible manner." R. PECCHIOLI, *supra* note 9, at 110.

portance of assessing and controlling their banks' exposure to international risk. The Basle Committee addressed these concerns by formulating broad supervisory principles of "best practices" in the proposed risk-based capital framework. In this way, the Committee seeks to achieve a degree of convergence of common banking standards. National authorities must now implement these guidelines through detailed arrangements best suited to their own national systems. While it may be necessary to develop some form of a legal mechanism, or to have the Basle Committee act as an international referee, the Proposal stands as an exemplary model of international banking cooperation.

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