The Proposed Risk-Based Capital Framework: A model of International Banking Cooperation?

Grace W. Chang*
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Abstract

The 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 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 purpose because it stands as a true model of international banking cooperation.
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. Supervision by national authorities over domestic banks no longer provides an adequate framework for regulating bank operations. On December 10, 1987, the Basel Committee on Banking Regulations and Supervisory Practices (“Basle Committee” or “Committee”) of the Bank for International Settlements (“BIS”) in Basle, Switzerland, announced a preliminary agreement by central bank governors of twelve industrialized nations for a proposed risk-based capital framework (“Proposal”). The Proposal seeks to set minimum capital standards for banks engaged in significant cross-border activities.

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

A. The Internationalization of Banking

International banking is now a major component of overall banking activity in many countries. Because of increased trade and capital flow among nations, there has been a growing tendency for banks to transact business through their foreign branch offices. Banks have recognized the strategic advantage of providing their clients with easy access to international markets. 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. International banks have also become intermediaries between oil-exporting and oil-importing countries because of a series of oil crises in the late 1970s.

Unfortunately, supervision of domestic banks has not kept

8. Hackney & Shafer, supra note 1, at 475.
11. R. Pecchioli, supra note 9, at 51.
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. 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 and the global debt crisis that emerged in 1982. National supervisory authorities have increasingly been confronted with problems arising from complex international banking structures and from differences in foreign regulatory policies. The differences in regulatory policies have created advantages for some banking nations and disadvantages for others. National supervisory authorities have been reluctant to modify their regulations for fear that any change will impair their banks’ competitive advantage.

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. 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.

20. R. Pecchioli, supra note 9, at 67.
22. Id.
23. R. Pecchioli, supra note 9, at 104.
B. The Basle Committee

The Basle Committee25 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-
amine risks that arise from international banking. The Basle Committee seeks to maintain a delicate balance between preserving national interests and freedom of the international marketplace.

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.


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] reiterates 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.\footnote{International Coordination of Bank Supervision, supra note 29, at 16.} The Committee has no direct power to implement any changes in national laws.\footnote{Id.} 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.\footnote{Id.} It is up to the member nations themselves to effect any changes in their national laws or regulations.\footnote{Id.}

For several years the Basle Committee has been working toward the goal of formulating an agreement for a more stringent capital framework.\footnote{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).} 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.\footnote{Bench & Sable, supra note 31, at 431.}

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.\footnote{Cooke, Overview, supra note 10, at 5.} The Proposal has two objectives.\footnote{Joint News Release, supra note 3, at 2; Measuring Foreign-Exchange, supra note 21, at 437.} First, it aims to strengthen the stability of the international banking system by fortifying the capital resources that banks are required to maintain.\footnote{Joint News Release, supra note 3, at 2; Measuring Foreign-Exchange, supra note 21, at 437.} Second, it seeks to remove competitive inequalities that arise from differences in national supervisory requirements.\footnote{Joint News Release, supra note 3, at 2; Measuring Foreign-Exchange, supra note 21, at 437.} Specifically, the Proposal includes a uniform definition of capital,\footnote{BIS Proposal, supra note 3, at 4-10, annex 1, reprinted in 27 I.L.M. at 533-38, 550-54.} a risk-based
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

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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.
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.\textsuperscript{56} The equation used to calculate adjusted primary capital is:

\[
[(\text{Tier 1} - \text{goodwill}) + \text{Tier 2}] - (\text{certain investments in other financial institutions}).\textsuperscript{57}
\]

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

\textbf{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”).\textsuperscript{61} Broadly speaking, the ratio measures weighted risk against ad-

\textsuperscript{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.” \textsc{L. Davids}, \textit{Dictionary of Banking and Finance} 105 (1978).

\textsuperscript{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. \textit{Id.}

\textsuperscript{57} \textit{Id.}

\textsuperscript{58} \textit{See supra} note 50.

\textsuperscript{59} Malloy, \textit{U.S. International Banking}, supra note 48, at 89.

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

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

\[
\left[ (\text{on-balance sheet item } \times \text{ risk weight}) + \left( (\text{off-balance sheet item } \times \text{ credit risk conversion factor}) \times \text{ risk weight} \right) \right] + (\text{allowances for loan and lease losses}) - (\text{appropriate adjustments}).
\]

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

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

\begin{itemize}
\item \textsuperscript{72} BIS Proposal, \textit{supra} note 5, annex 3, reprinted in 27 I.L.M. at 555-60. The framework primarily measures credit risk in the capital assessment. \textit{Id.} at 3, reprinted in 27 I.L.M. at 552. 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. \textit{Id.} The Committee is presently examining ways to incorporate these risks into the framework. \textit{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, \textit{Capital Adequacy, supra} note 5, at 21. These factors include
\begin{itemize}
\item 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.
\end{itemize}
\textit{Id.}

\item \textsuperscript{73} BIS Proposal, \textit{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:
\begin{itemize}
\item (1) Direct credit substitutes that substitute for loans. \textit{Id.} at 17, reprinted in 27 I.L.M. at 545. These items will have a 100\% credit risk conversion factor. \textit{Id.} For example, “general guarantees of indebtedness, bank acceptance guarantees and standby letters of credit serving as financial guarantees for loans and securities.” \textit{Id.}
\item (2) Trade-related contingencies will carry a 50\% credit risk conversion factor. \textit{Id.} For example, “performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions.” \textit{Id.}
\item (3) Short-term, self-liquidating trade-related contingent liabilities arising from the movement of goods will have a 20\% credit risk conversion factor. \textit{Id.} at 17-18, reprinted in 27 I.L.M. at 545-46. For example, documentary credits collateralized by the underlying shipments. \textit{Id.}
\item (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. \textit{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.\textsuperscript{74} The Proposal establishes five broad categories of risk weights: 0\%, 10\%, 20\%, 50\%, and 100\%.\textsuperscript{75} The greater the risk of the asset, the higher the risk weight assigned.\textsuperscript{76} On-balance sheet items go through a one-step process\textsuperscript{77} that is identical to the second step of the off-balance sheet process.\textsuperscript{78} The Proposal grants supervisory authorities flexibility in determining the appropriate category within which assets, both on-balance and off-balance sheet,
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. 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, which is used to measure the adequacy of a bank's capital structure.

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. This minimum amount, which is expressed as a percentage of assets, is referred to as capital adequacy. A sufficient level of capital adequacy also helps to create public confidence in a bank.

The Basle Committee has tentatively set the ultimate minimum target of capital adequacy at 8%. However, two member countries, West Germany and France, prefer to consult with their banks without being bound to a numerical standard. 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. National authorities would also be free to adopt higher levels or more stringent supplementary arrangements to measure capital.

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.
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.
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.
89. Id. at 3, reprinted in 27 I.L.M. at 532.
Overall, the proposed risk-based capital framework has three primary objectives. First, it provides an equitable and consistent basis for making international capital comparison among different banking systems. Second, it takes into account both on-balance sheet and off-balance sheet risk exposures in assessing capital adequacy. Third, it avoids deterring banks from holding liquid or low-risk assets.

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. It is significant because it addresses an area of great concern among national supervisors. It also makes progress toward international consistency and supervisory cooperation while minimizing global competitive distortions.

The Basle Committee recognizes that significant differences exist among countries in bank accounting and supervisory practices. The proposed framework has provided national authorities with some flexibility in implementing the risk-based capital measure. 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. Obtaining compliance with

91. Id.
92. Id.
93. Id.
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.
99. J. Baker, supra note 19, at 19. For example, United States bank supervision
the Proposal may thus be difficult. Moreover, two of the twelve members involved, West Germany and France, have not agreed to set a common minimum target capital standard. The other ten have agreed on 8% as the minimum capital ratio to be achieved.

The Proposal sets out broad categories for both the risk weights and the credit-risk conversion factors to provide national authorities with discretion in implementing the framework. 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, it may instead encourage banks to take on higher credit and interest-rate risks. 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). 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. 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.

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, Comparative Bank, supra note 81, at 121.

100. Friesen, Comparative Bank, supra note 81, at 121.
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.
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.\textsuperscript{111} For instance, the Proposal allows hidden reserves to be included in the calculation of capital subject to a discount of 55%.\textsuperscript{112} Hidden reserves are the unearned appreciation of assets.\textsuperscript{113} They are determined by calculating the difference between book value and market value of assets.\textsuperscript{114} Since hidden reserves are not considered capital by West Germany's current banking regulations,\textsuperscript{115} West German banks will find it easier to meet the minimum level of capital required.\textsuperscript{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.\textsuperscript{117} Japanese banking regulation currently allows Japanese banks to include up to 70% of hidden reserves in the calculation of capital.\textsuperscript{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.\textsuperscript{119} For another, some United States banks may have to raise additional capital to meet the minimum capital ratio of

\textsuperscript{112} BIS Proposal, supra note 5, annex 1, at 2, reprinted in 27 I.L.M. at 551.
\textsuperscript{114} See L. David, supra note 55, at 109.
\textsuperscript{115} Friesen, Part I, supra note 17, at 1102 n.215.
\textsuperscript{117} Id.
\textsuperscript{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
provisions. 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.192 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.


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.


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. Furthermore, reports of other regional banking groups' activities are included in Committee annual reports. In addition, discussions of the Committee's activities are held at periodic international conferences of bank supervisors. Finally, the Committee is also circulating the Proposal to the supervisory authorities of non-member nations with the hope of encouraging a worldwide standard of capital adequacy.

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. 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. 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

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 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).


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.\textsuperscript{141}

The forces that encourage compliance with the Proposal are essentially non-legal. For one thing, the agreement has political and moral weight.\textsuperscript{142} For another, member nations may comply because of what is referred to as “law habit.”\textsuperscript{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.\textsuperscript{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.\textsuperscript{145} There is, however, no legal forum to determine whether there was good faith.\textsuperscript{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.\textsuperscript{147}

\begin{itemize}
\item \textsuperscript{141} See Baxter, \textit{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.”).
\item \textsuperscript{142} See Editorial, \textit{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.”).
\item \textsuperscript{143} See Baxter, \textit{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.”
\item \textsuperscript{144} \textit{Id.} Indeed, the Basle Committee has been working on the problem of capital erosion since 1982. \textit{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. \textit{Id.}
\item \textsuperscript{145} Representatives of each member country “commit themselves to work in their countries for the principles agreed to by the Committee.” \textit{INTERNATIONAL COORDINATION OF BANK SUPERVISION, supra} note 29, at 16.
\item \textsuperscript{146} See Baxter, \textit{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.”).
\item \textsuperscript{147} \textit{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.”).
\end{itemize}
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.\(^\text{148}\) The Treaty of Rome, which established the EEC, provides the legal basis for the coordination of banking legislation.\(^\text{149}\) It provides for the use of a legal instrument, directives, to help promote the harmonization of banking legislation and supervisory cooperation.\(^\text{150}\)

The ultimate goal of the EEC's efforts is to achieve a uniform legislative and supervisory banking system throughout the Community.\(^\text{151}\) The EEC has to date enacted two legal directives, the First Banking Coordination Directive\(^\text{152}\) ("Coordi-
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
Moreover, two groups, including the so-called Contact Group, work with the EEC Commission to achieve harmonization. The Contact Group, which is much like the Basle Committee, provides an informal forum for the Member States' supervisory authorities. The purpose of the Contact

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. The supervisory authorities recognized the importance of developing practical cooperation to maintain adequate supervision in the face of the rapid pace of globalized banking. Despite the EEC's legal structure, however, harmonized banking within the Community is still in its infancy.

The modest accomplishments of the EEC's efforts at coordination 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. Clearly, international cooperation among supervisory authorities is an essential ingredient in accommodating national differences and achieving worldwide coordination of national banking supervision and regulation.

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-

163. See supra note 162 and accompanying text.
164. See 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. See supra note 148, at 37.
166. 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.
importance 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.

Grace W. Chang*