UNIT 5 BASEL CONCORDAT

Objectives

After reading this unit you should be able to:

- understand the role of the Basel Committee at the centre of International financial regulation.
- identify the principles laid out by the Basel Concordat
- the Franklin, Hersatt, Banco Ambrosiano, BCCI crisis and their consequences.
- appreciate the banking regulation has come to accept the model of balanced home country control with host country supervision.

Structure

5.1 INTRODUCTION

Until the Herstalt crisis of 1974 there was no formal machinery for co-ordinating national regulatory arrangements. As Peter Cooke of the Bank of England stated supervisors were still very much domestically oriented within the framework of different national banking systems. The disturbances that followed in the wake of Herstatt's collapse focused attention on the interdependence of national banking systems and led in the following year to the creation of a standing committee of bank supervisors "Cooke Committee" which seeks not to harmonise national laws and practices but rather to interlink disparate regulatory regimes with a view to ensuring that all banks are supervised according to certain broad principles.

5.2 HERSTATT CRISIS

In the late afternoon of June 26, 1974, Bankhaus I.D. Herstatt of Cologne was closed by German authorities. The bank had suffered huge losses in its foreign exchange department, which it had covered up with fraudulent book keeping. In particular the bank had speculated wildly in currency markets, borrowing in different currencies from banks around the world, and it had lost the gamble.

The losses that other banks suffered as a result of the Herstatt failure, however, were compounded by the actions of the German authorities. The late afternoon closure of the bank meant that when it was closed it was 10.00 a.m. in New York and 3.00 p.m. in London. Funds had already been credited to Herstatt's accounts by its global correspondents that same day and foreign exchange trading had only begun for the day in the United States. When news of the Herstatt failure came burning across the wires, trading stopped.

As Herstatt's creditors contemplated their next move, bank managers decided to provide only the highest rated institutions with foreign exchange; all others would be shut out. Thousands of smaller banks worldwide were simply unable to meet the foreign exchange demands of their customers through their traditional correspondent banking networks, tying up international trade. The crisis immediately spilled over into the interbank lending markets as a whole and small banks that were able to borrow were forced to pay substantially more for funds. One student of the affair argued that "the US clearing system nearly collapsed with Herstatt".

The German regulatory authorities suffered harsh criticism in the wake of the Herstatt closure. Many bankers said that the Deutsche Bundesbank should have honoured Herstatt's debts and should have intervened in the foreign exchange markets in order to support the smaller banks, which had been shut out. The Germans justified their actions by suggesting that they "wanted to teach speculators, as well as banks dealing with the speculators, a lesson".

Although it had international ramifications, the Herstatt failure was handled very much as a German internal matter. The bank lacked a far-flung branch network and its problems were centered in the head office. Accordingly, outstanding issues between the German authorities and Herstatt's creditor banks were dealt with bilaterally, either at the official level (that is, between the central bankers of Germany and other'countries) or at transnational levels (that is between the banks and authorities directly). Nonetheless, the Herstatt crisis did force banking supervisors in different countries to begin speaking with one another on a regular basis and sharing information and soon that process would become formalized by the Group of Ten central bank governors.

5.3 THE FAILURE OF FRANKLIN NATIONAL BANK OF NEW YORK

While German banking authorities were coping with the Herstatt mess, a second banking crisis occupied the attention of American officials. On October 8, 1974, the twentieth largest bank in the United States, the Franklin National Bank of New York, was declared insolvent and acquired by the German controlled European-American Bank. The aggressive management techniques of that bank had found their way to the trading floor, where Franklin bankers became avid speculators in currency markets. Fearing that the failure of the nation's twentieth - largest bank could lead to a nation wide depositor stampede and possibly to a global banking crisis, Federal Reserve authorities acted to prop up the ailing institution, adopting a fourfold policy; first, as lender of last resort it provided the bank with more than $ 1.7 billion in funds; second, it took over the bank's foreign exchange operations, basically providing a guarantee that Franklin National Bank, would not, like Herstatt, leave its foreign creditors unpaid; third, the Federal Reserve gave support to the bank's London branch, extending the lender-of-last-resort provision overseas; finally, along with the Federal Deposit Insurance Corporation, it found a buyer for the bank's assets.

In designing a policy response, the Federal Reserve worked closely with other central banks particularly the Bank of England which had some supervisory responsibilities for Franklin National's London branch. This permitted the London branch to be closed without a separate liquidation process. Furthermore the Federal Reserve's action stemmed any Euromarket fears concerning contagion beyond the Franklin National.

5.4 BASEL COMMITTEE AND THE ORIGINS OF INTERNATIONAL BANKING SUPERVISION

During the autumn of 1974, Bank of England Governor, Lord Richardson met his head of banking supervision George Blunden. They discussed the need for greater co-operation among bank supervisors and especially the Bank of England's requirement for more information from home country supervisors concerning the overall activities of foreign banks with branches and subsidiaries in London. At that time, banks did not present consolidated statements of their activities making it difficult, if not impossible, for supervisors in any single country including the home base, to assess the bank as a whole. Richardson decided to propose to his fellow central bank Governors that they establish a committee of banking supervisors which could have as its chief function the exchange of vital information.

At their monthly meeting in December 1974, the G-10 Central Banks' Governors, voted to support Richardson's idea, establishing the Standing Committee on Banking Regulation and supervisory practices now known informally as the "Basel Committee". The Basel Committee was charged with the following tasks;

- general education about how banks were supervised within the member countries;
- information sharing to include the passing of "sensitive information" on banks to supervisors who were hosts to its branches.
- the establishment of an "early warning system" to detect problems within international banks;
- conducting studies on topics in banking supervision; and
- policy co-ordination in supervising international and consortium banks.

In sum, there was agreement that the basic aim of international co-operation in this field should be to ensure that no foreign banking establishment escapes supervision. The Committee's role has moved well beyond its early Charter and; now it stands at the center of international financial regulation.

5.5 BASEL CONCORDAT

In its earliest efforts at supervisory co-operation the Basel Committee looked upon banking regulation as a task that had to be shared between the home and host country. This is evident in the first product of the committee, called Concordat, which was prepared in 1975, made public in-1981, revised in 1983 in the wake of the Banco Ambrosiano scandal and revised again in 1997, in the wake of the BCCI collapse.

The concordat laid out the five following principles.

1. The supervision of foreign banking establishment should be the joint responsibility of host and parent authorities.
2. No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments, are supervised and supervision should be judged adequate 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 regulation.
4. The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, whiie primary responsibility lies with the host authority parent authorities 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 co-operation would be facilitated by transfer of information between host and parent authorities and by the granting of permission to the inspection 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, however, failed to address a number of critical issues for international banking supervision. First, it left open the question of which, if any, Central Bank would support a commercial bank that had failed due to fraud; the Germans were consistent in their stated refusal to bail out such institutions. Second, the supervision of subsidiaries, and agencies remained unclear. Was a "moral commitment" the same as providing lender-of-last-resort support'? The third, and most important, the Concordat failed to discuss the lender of last resort, at least explicitly. In short, while the members of the Basel Committee found that the Concordat was useful as a conceptual framework, there were many questions about how (and if) it would work in practice.

In sum the Concordat marked a first, tentative step towards developing an internationally accepted approach to banking supervision. It emphasized the role of the home country's Central Bank in providing for the solvency needs of branches in trouble while giving host country regulator's added responsibility for supervision. But given its cautious wording, notable gaps and lack cf authority, it would prove a weak reed for managing international banking crises.

Soon after the committee accepted the concordat, a notable loophole in its coverage became apparent. Simply stated the parts of a bank might not add up to the whole. Home and host country supervisors might co-operate in painting an overall picture, but given different accounting rules and regulatory standards, and the large gaps in reporting within the banks themselves, the result could well be a partial view with important pieces obscured or missing.

The solution to this problem had already been discovered by the more sophisticated banks, which had developed consolidated reporting - that is reporting that looked at the institution's balance shcel and income statement from the perspective of an integrated entity. Taking this approach as its starting point, the Committee in 1978 recommended to the central hank Governors that banking supervision be conducted on the basis of consolidated statement.

The principle of consolidated accounting led to further strengthening of home country control. The Group of Ten countries had achieved important advances in the supervision of international banks with the Concordant and consolidation. Furthermore, the Basel Committee recognized that the power of these supervisory tools would be blunted if they remained solely in the hands of the Group of Ten countries. Accordingly, in 1979 the Committee prompted the banking supervisors from the major offshore centers, which were largely in the Caribbean to form their own organization and to adopt the supervisory principles already accepted in Basel. This "Offshore Group of Banking Supervision" commenced work in October 1980 and by 1982 it had worked out an agreement with the Basel Committee which extended consolidated accounting to offshore branches and subsidiaries.

These were not small achievements in themselves. But despite its collegiality and degree of common cause, the committee was proved too weak to cope with the next crises that came crashing down on the financial market place.

5.6 BANCO AMBROSIANO CRISIS

Banco Ambrosiano SpA, Italy's largest private hank with $ 6 billion deposits, faced a major capital deficiency arising from $ 1.4 billion of doubtful foreign loans which were routed through its subsidiaries in Latin America in 1982. As Ambrosiano verged on a liquidity crisis as depositors began to withdraw their funds, the Bank of Italy mounted a life-boat operation with the support of the nation's largest commercial bank. Soon thereafter, new stories began to leak concerning the bank and its myriad legal and illegal activities and networks. Unable to control the loss of confidence the Rank of Italy moved to close Banco Ambrosiano in August 1982, but not before protecting all of the parent bank's depositors from loss.

Yet the bank refused to provide the same treatment to Ambrosiano's overseas subsidiaries, particularly its Luxembourg office, which was the center of its Eurolending activities. Active in the interbank market as a source of funds, Ambrosiano owed various creditors' $ 450 million, who were not given protection by the Bank of Italy. For their part, Italian authorities claimed that they had no responsibility for the affairs of a foreign subsidiary which they neither supervised nor served as lender of last resort. Unfortunately Luxembourg also felt that it had no responsibility for the subsidiary, asserting that it did in fact fall under the supervisory umbrella of the Bank of Italy. In the end, Ambrosiano's Luxembourg subsidiary was left to default on its loans and deposits leaving creditors no choice but to fight their battle in the courts.

The Ambrosiano crisis had a number of consequences. From the perspective of the interbank market, as with the Herstatt failure, smaller banks found themselves paying more for money than their larger, better-known competitors.

Bank supervisors also drew lessons from the Ambrosiano affair. In Italy, the weakness of international banking supervision became a topic of widespread debate, leading to a change in the banking law, which required that banks provide consolidated statements. Yet the Italians did not draw the lesson that they had to provide lender-of-last resort support to subsidiary operations, especially in cases like Ambrosiano, where there was evidence of massive fraud. Peter Cooke the Chairman of the Basel Committee supported the Bank of Italy in this regard, pointing out that the Concordat related "to supervision responsibilities not lender-of-last resort responsibilities". The continuing ambiguity over which central banks did perform this function in international markets, however, would continue to dog the committee's work.

The failure of Luxembourg authorities to act as lender of last resort raised further questions about, the role of host country supervisors. According to the Concordat, the host country assumed primary responsibilities for regulating bank subsidiaries, but it is unclear whether Luxembourg had (or has) the capability to supervise and regulate a financial institution as complex as a multinational bank.

Nonetheless, the authorities in Luxembourg reformed their banking laws to some extent in the wake of Ambrosiano easing bank secrecy to certain areas and requiring banks subsidiaries to provide the information needed in order to facilitate the parent to prepare consolidated statements. Furthermore, the Luxembourg authorities sought "comfort letters" from parent banks indicating their support for the subsidiaries which were based in that country.

In the words of Richard Dale "the Ambrosiano affair represented a serious breakdown in international supervisory co-operation. From the point of view of preventive regulation a glaring loopholes in international supervisory arrangements had emerged. Indeed in the wake of Ambrosiano, the Basel Committee sat down to redraft its Concordat in an effort to close those very loopholes and reach a new understanding among its members.

5.7 THE REVISED BASEL CONCORDAT, JUNE 1983

The revised Concordat was released by the Committee in June 1983 under the title "Principles for the supervision of Banks' Foreign Establishments". From the outset, the document made clear that "its aims were quite limited". The report deals exclusively with the responsibilities of banking supervisory authorities for monitoring the prudential conduct and soundness of the banks' foreign establishments. It does not address itself to lender-of-last-resort aspects of the role of Central Banks". Furthermore, it stressed that the principles formulated were not 'laws"; instead they represented what the committee called "best practices".

General Principles governing the supervision of banks' foreign establishment

Effective co-operation between host and parent authorities is a central pre-requisite for the supervision of banks' international operations, In relation to the supervision of banks' foreign establishments there are two basic principles which are fundamental to such co-operation and which call for consultation and contacts between respective host and parent authorities ; firstly that no foreign banking establishment should escape supervision and secondly that the supervision should be adequate.

Aspects of the supervision of banks' foreign establishments

The supervision of banks' foreign 'establishment is considered from three different aspects; solvency, liquidity and foreign exchange operations.

1. **Solvency:** The allocation of responsibilities for the supervision of solvency, of banks'

foreign establishments between host and parent authorities will depend upon the type of establishments. For branches their solvency is indistinguishable from 'that of the parent bank. For subsidiaries the supervision of solvency is a joint responsibility of both host and parent authorities. For joint ventures the supervision of solvency should, normally for practical reasons, be primarily the responsibility of the authorities in the country of incorporation.

2. **Liquidity:** The host authority has responsibility for monitoring the liquidity of the foreign hank's establishment in its country. The parent authority has responsibility for monitoring the liquidity of the banking group as a whole. For subsidiaries primary responsibility for supervising liquidity should rest with the host authority. Parent authorities should take account of any standby or other facilities grented as well as my other commitments, for example, through comfort letters, by parent banks to these establishments.

3. ***Foreign exchange* operations *and position:*** These should be a joint responsibility of parent and host authorities. Hcst authorities should be in a position to monitor the foreign exchange exposure of foreign establishments in their territories and should inform themselves of the nature and extent of the supervision of these establishments being undertaken by the parent authorities.

The basic message of the new document was that home country supervision would be further strengthened through the continuing consolidation of bank statements and risk evaluations. The banks were to consolidate to the degree that supervisors could analyse the capital of the group, the quality of its worldwide assets, and its exposure to risk, especially in its foreign exchange position. In those cases where the bank was unable to consolidate adequate information about a foreign operation (owing to, for éxample, secrecy laws) and where it could not rely upon the host authorities the home country supervisors "should be prepared to discourage the parent bank from continuing to operate the establishment in question".

Home country supervision of international banking, was thus the fundamental principle that suffused the Basel Committee. Despite a number of international banking failures in which home country supervision appeared less than adequate the Committee did not recommend a supranational response to regulation.

5.8 BCCI AND AFTER

On July 5, 1996 the worldwide offices of the Bank of Credit and Commerce International (BCCI) were closed in a co-ordinated shut down initiated by the Bank of England. The official investigation undertaken revealed that the bank was serving as the hub of an international crime network, involved in money laundering and illegal trafficking in drugs and weapons.

BCCI was a regulator's nightmare and its structure was expressly designed to escape consolidated supervision. The bank was headquartered in Luxembourg, operated out of London and owned largely by Abu Dhabi. "It spread globally like a virus, escaping the normal regulatory vaccines until an international effort was made to kill it".

BCCI was designed to hinder effective regulation. It engaged two auditors to examine the separate books of its subsidiaries and no consolidated accounts were made of the holding company. Although under the Basel Concordat principles the bank should have been regulated by the Luxembourg Monetary Institute (LMI), the vast majority of its operations occurred outside the small country; indeed the Luxembourg authorities admitted in a later testimony that "it was impossible to examine adequate consolidated supervision of a group 98 percent of whose activities fell outside its jurisdiction".

The Bank of England claimed that it was not the chief regulator of BCCI: that was the job of LMI.

On the suggestion of British and Luxembourg officials, the members of the Basel Committee took the extra-ordinary step of forming a "College of Regulators" in 1987, with the objective of trying to gain a larger view of BCCI's operations. With the closure of the bank in July 1991 'the Committee reviewed its experience not only with the college concept but also with the Basel Concordat. Both were found wanting.

The lesson that the Committee drew from the College of Regulators was that it "is not a full substitute for a clearly designed lead supervisor who can effectively monitor it worldwide. Much has been made of the opaque structure of BCCI as an impediment to effective supervision. From now on supervisors will be increasingly wary of any major banking group which is structured in a way which makes consolidated supervision difficult to achieve".

The College fell victim to the classic problem of collective action. As auditor Price Waterhouse said "In our experience of dealing with the College each regulator tended to focus on its own domestic concerns rather than accepting full Collegiate responsibility".

5.9 LESSONS FROM BCCI

The BCCI affair prompted reconsideration of changes in the domestic supervisory practices of overseas banks in UK, immediately followed by India.

1. Host country to have the following in place:
   a) The Bank, Central Bank of the country to extend on-side supervision.
   b) The Bank to devote more resources to search for fraud.
   c) A duty to be imposed on auditors to report suspicion of fraud or malpractices to the Bank.
   d) Overseas banks to be subject to a full-scope review by reporting accountants on an annual basis.
   e) "Minimum criteria" for authorization to be strictly interpreted.
   f) The Bank, if necessary, to be given an explicit power to refuse or revoke authorization on the ground that the applicant or bank cannot be effectively supervised because of the group's structure.
   g) Co-operation and co-ordination between the Bank and other non-regulatory public bodies to be enhanced.
2. Other International Arrangements:
   a) Supervisory standards to be subject to independent monitoring
   b) International supervisory co-operation to be enhanced.
   c) The problem of bank secrecy provisions to be tackled.

In the aftermath of BCCI, the United States acted to strengthen international banking supervision, in two fundamental ways; first, it demanded consolidated 'home' country supervision as the basis for foreign bank entry into the USA, second, as a powerful host country, it reserved for itself the right to grant banking licences and to determine safe and sound banking practices. With the former it continued a trend that has long been in evidence among supervision - namely the trend towards emphasizing home country control. But with the latter, it enhanced the power of the Federal Reserve over other government agencies in banking regulation, the central bank had become primus inter pares on banking matters. Thus the US model balanced home country control with host country supervision.

5.10 THE NEW CONCORDAT 1992

The 'new' Concordat, released by the Basel Committee in June 1992, articulates the following principles of international banking supervision:

1) All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision.
2) The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's, if these are different from the banking group's home country supervisory authority.

3) Supervisory authorities should posses the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor.

4) If a host country authority determines that any of the foregoing minimum standards is not met to its satisfaction that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

The direction that the banking regulation has taken after each crisis has remained remarkably consistent, namely an increased emphasis on home country control. During the 1970s and early 1980s home country control was enhanced through consolidated supervision and information sharing among regulators; in the late 1980s and early 1990, regulations would be strengthened through the articulation of minimum regulatory standards in areas such as capital adequacy that bank's home country was expected to monitor. Following the collapse of BCCI new rules for defining the home country were implemented by the Basel Committee re-emphasising home country controls, but at the same time strengthening the role of host country supervisors.

Activity 1

The important tasks of Basel Committee were :

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5.11 SUMMARY

In the wake of Herstatt and Franklin National Bank failures, G10 Central Bank Governors established the Standing Committee on Banking Regulation and Supervisory Practices now known as the "Basel Committee". In its earliest efforts of supervisory co-operation the Basel Committee looked upon banking regulation as a task that has to be shared between the home and host country.

The direction that banking regulation has taken place after each crisis - Herstatt, Franklin, Banco Ambrosiano, BCCI - has remained remarkably consistant - namely an increased emphasis on home country control. During the 1970s and early 1980s, home country control was enhanced through consolidated supervision and information sharing among regulators. In the late 1980s, and early 1990s, regulation would be strengthened through the articulation of minimum regulatory standards in areas such as capital adequacy that home country was expected to monitor. Following BCCI collapse, new rules for defining the home country were implemented by the Committee, re-emphasising home country control but at the same time strengthening the role of host country supervision.

5.12 SELF ASSESSMENT QUESTIONS

1. Describe the backdrop to Basel Concordat.
2. Discuss the principles of Basel Concordat 1975, its deficiencies and the attempts to remedy them.
3. Outline the principles of the revised Basel Concordat (June 1983)
4. Discuss the principles of the new Basel Concordat 1992.
5. What are the lessons from BCCI?
6. Write short notes on :
   a) Herstatt Crisis
   b) Banco Ambrosiano Crisis
   c) Franklin National Bank Crisis
   d) BCCI collapse

5.13 FURTHER READINGS

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UNIT 6 LEGAL ISSUES IN INTERNATIONAL BANKING

Objectives

After studying this unit, you will be able to:

- understand the need for the parties to stipulate the choice of laws,
- identify the various factors influencing the choice of laws,
- define the meaning of jurisdiction in the context of international law, and its applicability to subjects,
- appreciate the legal and practical problems associated with sovereign immunity, restrictive sovereign immunity in the US and the UK,
- describe the Big Mullah theory problems of execution of the judgement and the Act of State Doctrine (USA).

Structure