The Basle Committee on Banking Supervision – a secretive club of giants?

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I. Introduction

Since the breakdown of the Bretton Woods system in the early 1970s, the financial landscape has experienced profound and dramatic changes. The progressive elimination of official barriers to capital flows and the advances in communications and information technology encouraged banks and other financial market participants to explore the opportunities offered by the liberalised and computerised business environment. They also raised concerns with regard to the effectiveness of the control systems which were in place: while banking became international, banking regulation remained essentially domestic.

Weaknesses in the prudential oversight system aggravate the risk of bank failures. Because of the increasing international linkages, such failures can easily affect the financial system as a whole. Therefore, the internationalisation of banking made it necessary to upgrade the framework of prudential supervision by adopting international standards rather than keeping a domestic regulatory focus.

A key player in generating international standards of banking supervision is the Basle Committee on Banking Regulations and Supervisory Practices (Basle Committee). The Basle Committee lacks the status of an international organisation. Its Accords, Concordats and Core Principles are not legally binding. Nevertheless, they have become the regulatory standard for virtually all states with international banking activities. Thus, the Basle standards are part of an increasingly important body of international financial regulation which is generated by actors who operate outside the traditional international law categories. This paper examines the circumstances surrounding the establishment of the Basle Committee, its organisational structure, its method of operation, its regulatory programme and its impact on international banking oversight.

In particular, it will highlight the Basle Committee’s pivotal role in securing international convergence of prudential banking supervision.

II. The Basle Committee – a secretive club of giants?

International banking regulation is a crisis-driven process: it has consistently been enacted in the wake of a major banking scandal. The experience of the collapse of ‘Bankhaus Herstatt’ in 1974¹ led the bank governors of the Group of Ten (G10)² to form what came to be known as the Basle Committee on Banking Supervision. Its aim was to ‘eradicate the worrisome disjunction between the international banking system and the plethora of national banking regulations that have failed to restrain it.’³ In order to achieve this, the Committee sought to establish an informal forum for consultation and co-operation among the supervisory authorities of the G10 states.

The forum’s task is to develop effective supervisory techniques and to promote the convergence of the disparate national supervisory frameworks. It studies and makes recommendations on areas of prudential concern and establishes channels to facilitate the exchange of information among bank supervisors. Rather than attempting to unify the national prudential regimes, the Committee seeks to link them with a view toward ensuring that all banks are supervised according to common principles.⁴

Today, the Committee’s members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of the banking business where this is not the central bank. The Committee’s twelve-person Secretariat is provided by the BIS. It is mainly staffed by professional supervisors on temporary secondment from member institutions. The Committee itself meets every three months. It operates through a rotating chair and makes its recommendations by consensus. An important motor for its prudential activity are the thirty or so technical working groups and task forces, many of which meet on a regular and frequent basis. The Committee reports to the central bank Governors of the G10 countries and seeks the Governors’ endorsement for its major activities.

The Basle Committee is a rather informal type of organisation. It is, quite simply, an agreement between the G10 central bankers. Consequently, it lacks the status of an international organisation. Also, it has no public bylaws. In fact, its existence was first marked, on 12 February 1975, by a press release issued through the BIS. It took five more years before the founding agreement was released to the public. The latter illustrates another characteristic of the Basle Committee: considering its indisputable influence on the world of finance, it is a rather discrete type of organisation. As former Committee Chairman Huib J. Miller has observed: ‘We don’t like publicity. We prefer, I might say, our hidden secret world of the supervisory continent.’

Moreover, most member governments are not directly involved in the activities of the Committee. The Committee members are the central banks and the supervisory agencies. These entities are sub-state actors of a special kind: they normally enjoy a great deal of independence from the legislative and executive branch of their government. Furthermore, the technicality of much of the Basle rule-making has helped to insulate the Committee’s activities from the scrutiny of the national law-makers: topics such as capital adequacy or credit risk modelling are brain-teasers for anyone active in the respective field of study; its formulas are unspeakably dull for anyone else.

Lastly, the Committee has chosen to refrain from taking on new members. This accounts for a another characteristic of the Basle Committee: it is not only a rather informal and rather private, but also a rather exclusive circle. Although the Committee has been the driving force behind the harmonisation of banking regulation around the globe, membership is limited to the most industrialised and wealthy. In the words of H. P. Tarbert, 'The Basle Committee is truly a club of giants.'

In recent years, however, the low-key attitude of the Committee has somewhat lessened. First of all, the Committee became a victim of its own success: its 1988 capital adequacy framework (Basle Capital Accord) has become the capital adequacy standard worldwide. This also led to a more acute awareness of the Committee’s existence. With the revision of the Accord currently in the working, the Basle Committee receives a considerable amount of press coverage. Furthermore, the increasing relations with other bank supervisory groupings or single supervisory agencies has generated additional insights into the Committee’s workings, as the non-members are sometimes invited to participate in technical groups and task forces. Lastly, the Basle Committee has become much more accessible and ‘public’ because of their work out of the public gaze. They are most effective when they are least noticed.’


For a discussion of the governmental and judicial non-involvement in this area of international law see see Raj Bhala, 'Equilibrium Theory, the FICAS Model, and International Banking Law' (1997) 38 Harvard International Law Journal, 1 at 23–4.

The notable exception is Spain, which joined the G10, and consequently the Basle Committee, in February 2001.

incorporated\(^{20}\) the principle of \textit{consolidated supervision} as one of the core supervisory techniques for international banking groups.\(^{21}\) The second important principle established by the Revised Concordat was that of \textit{dual key supervision}.\(^{22}\)

The Revised Concordat of 1983 had corrected some major flaws of the Concordat of 1973. However, the unfolding of another banking scandal revealed that important loopholes remained. The Concordat had abstained from assigning clear supervisory responsibilities for supervising holding companies.\(^{23}\) This made it possible for BCCI, a holding company headquartered in Luxembourg, to evade supervision by setting up a complex, multinational structure. When, through the co-ordinated efforts of the regulators of eight states, its activities were finally halted, BCCI had accumulated liabilities of US $10.64 billion while retaining assets of only US $1.1 billion.\(^{24}\)

In response to the BCCI scandal, the Basle Committee reformulated certain principles of the Revised Concordat as \textit{Minimum Standards} in 1992. The first Minimum Standard states that: 'All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision.' Other new requirements include the condition that an international bank must obtain permission from both its home and host country regulators prior to opening a cross-border establishment, and that a host regulator should prevent the establishment of the bank in its


\(^{18}\) Banco Ambrosiano, an Italian bank with a subsidiary in Luxembourg, was left short of US $450 million in its liabilities to its creditors after its subsidiary had made loans of US $1.4 billion to Latin American companies. The incident gave rise to a controversy between Italy and Luxembourg over who should have exercised supervision and who should be the lender of last resort. See Alford, \textit{Basle Committee Minimum standards}, above note 1, at 251–2; Daniel M. Laffer, 'Putting super back in the supervision of international banking, post BCCI' (1992) 60 Fordham Law Review, 470 n. 18.


\(^{20}\) The principle itself was adopted in 1978, see Cooke, \textit{The Basle Concordat}, above note 19, at 153.

\(^{21}\) Under this principle, the home authority would be responsible for monitoring the overall exposure of the bank, taking into account its worldwide operations, whereas the host authorities were deemed to have primary responsibility for supervising the branches or subsidiaries. See Revised Basle Concordat, above note 19.

\(^{22}\) See Revised Basle Concordat, above note 19.

\(^{23}\) Under this approach, parent and host authorities are encouraged to assess the quality of each other’s supervision. Where the host authority supervision was deemed inadequate, the parent authority should either extend its supervision or curtail the parent bank to continue to operate the establishment in question. See Revised Basle Concordat, above note 19.

jurisdiction if it is not satisfied by the home countries ability to exercise consolidated supervision.25

A notable exception to the mainly crisis-prompted regulation was the development of the ‘Core principles for Effective Banking Supervision’ in 1997. The Principles provide a blueprint for an effective supervisory system. The incentive came from a call of the G7 heads of government that the Committee participate in efforts to improve supervisory standards in the emerging markets. The principles were developed in collaboration with many non-G10 central banks and supervisory authorities.26

The continuous discussion and collaboration among the members of the international supervisory community led the Basle Committee to extend its focus beyond the supervision of cross-border banking in the strict sense. To date, the key documents alone fill a three-volume compendium.27 They address issues ranging from the evaluation of internal control systems to the special risks of electronic banking. Among this myriad of topics, however, stands out one core issue to which most of the Committee’s time has been devoted since the mid 1980s: Capital Adequacy.

2. Substantive regulation: the Basle Capital Accords

In its founding period, the Basle Committee filled a vacuum concerning transborder regulatory coordination of banking regulations. Consequently, during the first ten years of its existence, it focused on the modalities for international co-operation. Thus, the capital adequacy rules, being substantive in nature, were beyond the initial scope of the Committee’s activities. This began to change when, in the early 1980s, there was a mounting concern that the capital ratios of the main international banks were deteriorating just at the time that international risks, notably those vis-à-vis heavily indebted countries, were growing. In addition, the globalisation of finance and of financial institutions made increasingly evident that differences in national capital requirements were a source of competitive inequality. Thus, capital adequacy became a main concern for the central bankers who, at the same time, represented their country in the Basle Committee. Their regulatory concerns led to a transition of the Committee from its procedural approach toward the design of substantive prudential rules for capital adequacy.28 In 1988, a capital measurement system, commonly referred to as the Basle Capital Accord, was approved by the G10 governors.29

Even though the 1990s saw several revisions and refinements of the Capital Accord, it remained flawed in several respects, namely with regard its apportionment of all assets in one of four risk categories. In more general terms, its rules proved too simplistic and rigid for the complex world of international banking.30 Over time, there was an increasing pressure on the regulatory authorities to revise the Accord.31 In June 1999 and January 2001, the Committee issued its first and second consultative package for a new capital adequacy framework, commonly referred to as ‘Basle II’ or the ‘New Capital Accord’. The New Capital Accord intends to improve the way regulatory capital requirements reflect underlying risks and to better address the financial innovation that has occurred in recent years.32 The framework itself


30 For instance, the Accord flatly fixed banks’ capital at 8% of their risk-weighted assets. For an account of the ‘seven deadly sins’ of the Capital Accord see Tarbert, Rethinking Capital Adequacy’, above note 3, at 792–402. The Accord is viewed by some as a key catalyst for the 1990s recession and the Asian financial crisis: ibid., 794. See also Scott and Wellons, International Finance, above note 28, at 245.


IV. The Basle rule-making – regulation through co-operation

There is a general agreement that the Basle documents are not legally binding. The Committee itself emphasises the lack of legislative authority:

'The Committee does not possess any formal supranational supervisory authority. Its conclusions do not have, and were never intended to have, legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques."

As an illustration of this principle, the Basle 1988 Capital Accord articulated that the supervisory authorities will introduce and apply these recommendations in light of their different structure and existing supervisory arrangements. Over the years, however, the rhetoric has become more self-assured. The New Accord simply notes that it 'will be applied' to internationally active banks, whereas the explanatory note to the Accord states that it will be implemented by the Committee member countries and that the Committee 'expects that it will also be adopted by supervisors across the world'.

Thus, while not actively involved in law-making, the Basle Committee acts as a generator for the national law-making process. At the heart of this process lies the consensus among its members on the proposal in question. One observer has described the Basle process as 'gentleman's agreement among central banks'. In more technical terms, the Basle rules constitute international financial 'soft law'. The consensus

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38 Zaring, 'International Law by Other Means', above note 6, 282.
upon which this rule-making is based assures that the different regulatory backgrounds of its members are taken into account. This, in turn, enhances its chances to be implemented in the domestic context. Whereas the Basle rules are to be considered as soft law, they will, however, often acquire binding force in the process of their implementation within the domestic regime: once the Basle rules are adopted into national laws, they become hard law within that country.\textsuperscript{45}

V. Basle’s impact – a centrifugal force for international convergence

The original lack of the binding legal force of the Basle documents is in stark contrast to its effective regulatory significance. This is because, as pointed out above, it is regularly integrated into formal domestic law or regulatory practice. One illustration of the growing awareness of the Committee’s regulatory impact has been the attempt, by some members, to preempt the Basle process through prior enactment of domestic rules.\textsuperscript{46} More generally, the effect of the Committee’s various instruments has been that all states with international banks of significant size have reformulated their jurisdictional approaches to prudential supervision. This is particularly true for Basle’s most successful ‘product’, the Capital Accord. Noting that the absence of a legally binding treaty has not prevented capital adequacy laws to be virtually identical throughout the world, H.P. Tarbert has called the Accord a ‘peerless breed of internationalised national law’.\textsuperscript{47}

One reason for the Committee’s ability to act as a catalyst in generating and shaping national rules and practices beyond its exclusive membership circle is the quality of its work. Another is its prestige. An important additional factor is the market power of its members, who happen to be the states with the world’s largest banking markets. Their interest in

creating a level playing field for their own banking industry prompts them to ‘encourage’ non-member supervisory authorities to adopt the Basle standards. For instance, the Basle standards and practices can be made a condition for the foreign bank who wants to do business in a member country. Also, the member country can prevent its banks from opening a subsidiary or branch in a non-member country which is not in compliance with important Basle principles. Another crucial vehicle by which the Committee’s influence has been expanded is the IMF. This de facto central bank of last resort will, when approving and monitoring its bailout packages, examine the strength of the governmental banking supervision of the recipient country. It does so by referring to the Basle principles.\textsuperscript{48} Lastly, the Committee’s influence has also been helped by the endorsement of its principles, notably its capital adequacy framework, by another key market player: the rating agencies.\textsuperscript{49}

Thus, for a non-member country who refuses to comply with Basle’s soft law, the consequences are anything but soft. The fact that non-member countries, especially of less industrialised parts of the world, are forced into the level playing field of the G10 Club of Giants, sheds a somewhat different light on the Basle process. From a more critical perspective, Basle’s rules appear as undifferentiated inculation of domestic law by the rich country bank supervisors. Instead of characterising them as ‘soft law’, it has been suggested to refer to them as central bankers’ ‘Club’ law.\textsuperscript{50}

VI. Conclusion

Modern banking has become internationalised. An effective supervision of the banking industry requires co-ordination among the national supervisors and adherence to international supervisory standards. The centrifugal force in this process has been the Basle Committee on Banking Supervision. The Basle Committee is not a formal international organisation in an international law context. Nonetheless, it has evolved


\textsuperscript{46} On the use of the so-called ‘Bis-ratio’ by the rating agencies see Zuberbühler, ‘Revision des Capital Accord’, above note 33, at 136.

into an unmatched catalyst for the convergence of law-making in the area of international prudential banking regulation. The Basle documents constitute international regulatory soft law. One benefit of Basle’s soft law approach is that it offers the possibility of strengthening international banking supervision without the imposition of a new formal legal framework or direct interference with national sovereignty. The voluntary approach built into the formulations of the Basle documents make them flexible enough for implementation in disparate regulatory systems. Furthermore, the exclusivity of its membership assures the efficiency which is needed for a timely regulatory reaction in the rapidly developing field of international banking.

On a more critical note, some scholars have rightly pointed out that the Committee’s activities are somewhat outside of the regular constitutional context of law-making. As the Committee lacks the status of an international organisation, it is not only excluded from the prerogatives, but also exempted from the potential discipline of international legal personality. 51 This discipline is not achieved on the domestic level either. In fact, there is a near complete non-involvement of the national law-makers in the Basle process. This has allowed international banking regulation to become a sort of ‘club’ law, designed and forced upon the world by rich country banking supervisors who act outside the democratic control mechanisms of their home government. 52 So far, however, regulatory alternatives which could achieve Basle’s impact while being less of a ‘secretive and undemocratic engine of regulation’ 53 have yet to be developed. Considering its past accomplishments in the international regulatory convergence process, it can be assumed that the Basle Committee will continue to play a crucial role in international financial regulation.

51 For an account why the Basle Committee does not meet the requirements of an international organisation see Zaring, ‘International Law by Other Means’, above note 6, at 285.
52 On the ‘democratic deficit’ of the Basle Committee see Zeitler, ‘Internationale Entwicklungslinien’, above note 33, at 1400.
53 Zaring, ‘International Law by Other Means’, above note 6, at 327.

I. Introduction

Financial crises have occurred throughout the history of capitalism – from the Dutch tulip mania in 1637–8 and the Indian cotton futures market crash of 1866, over the Great Depression of 1929, to the financial crises of the 1980s and 1990s.

While industrial countries have reduced the incidence and severity of financial crises over the last seventy years, financial crises have become more frequent in developing countries since the 1980s. With every such wave of crises, there are calls for major changes in the governance of financial markets, aimed at improving their efficiency, reducing their vulnerability and increasing their legitimacy. And while sometimes these calls are indeed heeded, in particular when major disruptions occur, many times the appetite for a grand new design diminishes as economies recover. To some extent, this can be said about the latest discussion regarding economic governance of financial markets – which rose to prominence as a quest for a ‘new international financial architecture’. 1 Still, with Argentina in severe distress and clouds hanging over Brazil and Turkey, this might be a good time to revisit some of the reforms proposed and enacted in the wake of the ‘international financial crises’ 2 of the 1990s – the tequila crisis in Mexico 1995, East Asia in 1997–98, Russia in 1998, and Brazil in 1998–99. Specifically, this article will look

The author is World Bank staff. However, the views expressed in this essay are those of the author and should not be attributed to the World Bank, to its affiliated organisations, or to members of its Board of Executive Directors or the countries they represent.

1 Barry Eichengreen, Toward a New International Financial Architecture: A Practical Post-Asia Agenda (Washington, DC, 1999).