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Emerging International Regime of Financial Services Regulation

Michael P. Malloy
University of th e Pacific, McGeorge School of Law

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I. INTRODUCTION

Scholars of U.S. bank regulation have long noted the growing significance of multilateral sources of rule-creation. U.S. adherence to the General Agreement on Trade in Services ("GATS"), including banking services,[1] and U.S. membership in the North American Free Trade Agreement ("NAFTA"), which includes rules for trade in financial services within the region,[2] will doubtless have obvious effects on financial services regulation as these two multilateral regimes continue to mature. Of immediate interest, however, is the influence of the undertakings of the Bank for International Settlements ("BIS"), in which U.S. bank regulators have been participating directly. This essay focuses primarily upon the new capital adequacy accord for internationally active banks proposed by the BIS, popularly referred to as "Basel II," which is intended to replace the capital adequacy guidelines in full operation from 1992. The BIS has already had an impact on banking regulation that, for the present, far exceeds the GATS and NAFTA.[3]

 Portions of this essay are drawn from the author's forthcoming book, BANKING IN THE TWENTY-FIRST CENTURY, to be published by Carolina Academic Press. An earlier version of this essay was delivered at a meeting of the Irish Society of International Law in Dublin in November 2003.

** Distinguished Professor and Scholar, University of the Pacific McGeorge School of Law. J.D., University of Pennsylvania; Ph.D., Georgetown University.

1. General Agreement on Tariff and Trade: General Agreement on Trade in Services, annex. 1B, 33 I. L. M. 1168 (1994) [hereinafter GATS]. On the significance of the GATS for bank regulation, see Chantal Thomas, *Globalization in Financial Services–The Roles of GATS*, 21 ANN. REV. BANKING L. 323 (2002); Michael P. Malloy, *International Financial Services: An Agenda for the Twenty-First Century*, 15 TRANSNAT'L LAW. 55 (2002); Joel P. Trachtman, *Trade in Financial Services under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 COLUM. J. TRANSNAT'L L. 37 (1995).

2. North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., *reprinted in* 32 I. L. M. 289-397, 605-779 (entered into force Jan. 1, 1994) [hereinafter NAFTA]. On the significance of the NAFTA for bank regulation, see Art Alcausin Hall, *International Banking Regulation into the 21st Century: Flirting with Revolution*, 21 N.Y.L. SCH. J. INT'L & COMP. L. 41 (2001); Trachtman, *supra* note 1.

3. One reason for the relative influence of the BIS may be that the impact of other multilateral regimes has been blunted by specialized rules and exceptions that limit their binding effect on bank regulatory practices of national regulators. *See, e.g.*, Michael P. Malloy, *Financial Services Regulation after NAFTA*, *in* THE FIRST DECADE OF NAFTA: THE FUTURE OF FREE TRADE IN NORTH AMERICA (Kevin Kennedy, ed. 2004) (arguing that "the practical effects of [NAFTA] obligations are likely to emerge only incrementally, and those effects will have an impact largely cushioned by the intervention of reasonable measures domestically imposed for prudential reasons").

A. Themes of the Essay

The theme of the essay is two-fold. First, given the current significance of the work of the BIS for rule-creation in national bank regulatory systems, it is important to begin the process of analysis and assessment of Basel II on its own terms. Second, stepping back from the current project of the BIS, the essay will suggest the work of the BIS, as a whole, represents an emerging source of international law applicable to financial services providers operating in international markets.

B. The Bank for International Settlements

The BIS, located in Basel, Switzerland, is a multilateral bank for national central banks.[4] Traditionally, it has been primarily supported by the "Group of Ten" large industrialized democracies ("G-10"), consisting of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, United Kingdom, and the United States, with Switzerland as an additional significant participant. The BIS assists central banks in the transfer and investment of monetary reserves and often plays a role in settling international loan arrangements. Of increasing significance is its role as a forum or catalyst for international monetary cooperation and regulatory policy development.

In 1974, the failure of Herstatt Bank in Germany and Franklin National Bank in New York, with financial repercussions throughout the increasingly "internationalized" banking market, led the G-10 to sponsor an informal understanding on the resolution of international bank failures, known as the Basel Concordat. The Governors of the BIS acknowledged the need to establish a framework of multilateral bank supervision, so they formed the Committee on Banking Regulations and Supervisory Practices, now known as Basel Committee on Banking Supervision ("the Committee"). The Committee currently consists of foreign exchange and supervisory officials from the G-10, plus officials from Luxembourg, Spain, and Switzerland.

The Committee promotes cooperation among national regulators. It facilitates the establishment of broadly delineated principles to guide the differing national supervisory systems in establishing their own detailed arrangements. This was the approach taken by the 1974 Concordat in establishing a set of broad principles for the resolution of future bank crises. The broadness of the guiding principles articulated in the 1974 Concordat proved to be insufficient when Banco Ambrosiano, based in Italy with a subsidiary in Luxembourg, failed in 1982. Italian authorities first indicated that, from their perspective as "lender of last resort" to the bank, they would honor only Ambrosiano's domestic (i.e.,

4. For extended discussion of the BIS, see MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION §§ 9.7-9.9 (2d ed. 2003).

Italian) obligations, causing great distress in the banking world. Eventually, a large group of creditor banks of the Luxembourg subsidiary reached a settlement with the Italian central bank, involving more than $300 million in subsidiary obligations. One result of the difficulties of resolving this multinational bank failure was the revision of the Concordat in 1983.[5] The revision articulated in greater detail supervisory responsibilities with respect to multinational banking enterprises.

Since the issuance of the Basel Concordat, the Committee has given further attention to the problems of supervising transnational banking enterprises. An April 1990 Supplement to the Concordat sought to strengthen the principle of effective information flow between home-country and host-country authorities,[6] by making the rules on information transfer more explicit and detailed.

The 1991 scandal surrounding the collapse of the Bank of Credit and Commerce International ("BCCI")[7] subsequently caused the BIS Committee to review the arrangements for coordination of international bank supervision, which had proved inadequate in the events surrounding the BCCI collapse. Hence, in June 1992, the Committee took the further significant step of issuing a report establishing minimum standards on the supervision of international banking enterprises.[8] While the standards were not, on their own terms, binding on states, the states participating in BIS were expected to implement them, and other states were encouraged to do so. In the United States, implementation occurred primarily in connection with the enactment of the Federal Deposit Insurance Corporation Improvements Act.[9]

More recently, the Committee, in conjunction with the International Monetary Fund and the International Bank for Reconstruction and Development, developed a set of core principles for effective banking supervision.[10] The Core

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5. Bank for International Settlements, *Committee on Banking Regulations and Supervisory Practices, Principles for the Supervision of Banks' Foreign Establishments, in* MICHAEL P. MALLOY, INTERNATIONAL BANKING 55–60 (1998) [hereinafter MALLOY].

6. Bank for International Settlements, *Committee on Banking Regulation and Supervisory Practices: Supplement to the Basel Concordat Ensuring of Adequate Information Flows between Banking Supervisory Authorities, in* MALLOY, *supra* note 5, at 61–64.

7. For a review of the BCCI scandal and the legislative reaction to the scandal in the United States, see RAJ K. BHALA, FOREIGN BANK REGULATION AFTER BCCI (1994).

8. Bank for International Settlements, *Basel Committee on Banking Regulation and Supervisory Practices: Report on Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishment, in* MALLOY, *supra* note 5, at 64–68.

9. *See, e.g.*, 12 U.S.C. § 3105(d)(2)(1)(A) (approval of U.S. branch of foreign bank; comprehensive supervision of applicant on consolidated basis by home state authorities required); § 3105(d)(3)(A) (same; consent of home state to establishment of U.S. branch as standard of approval by U.S. authorities); § 3105(e)(1)(A) (termination of U.S. office of foreign bank when foreign bank not subject to comprehensive supervision on consolidated basis by home state authorities).

10. Basel Committee on Banking Supervision, *Basel Core Principles for Effective Banking Supervision*, 37 INT'L LEGAL MAT. 405 (1998) [hereinafter Core Principles]. The principles are, of course, not binding in themselves, but "serve as a basic reference for supervisory and other public authorities in all countries and internationally." *Id.* at 407.

Principles consist of twenty-five basic principles, ranging from preconditions for effective banking supervision (Principle 1) to principles for cross-border banking (Principles 23–25). Significantly, the principles address in detail prudential regulations and requirements (Principles 6-15), which have the effect of requiring careful supervision of management operations and internal controls.

C. Capital Adequacy

The BIS was also responsible for what is perhaps the most influential contemporary development in the international supervision of banking—the formulation of uniform guidelines governing the measurement and enforcement of capital adequacy of banks.[11] In U.S. practice, capital adequacy requirements predate the BIS efforts.[12] However, the rules developed under BIS auspices were aimed not only at a capital adequacy regime that would be effective as a purely regulatory matter, but also one that would encourage a multilateral convergence of regulatory standards. What is significant in the present context, however, is that the U.S. regulators chose to apply this multilateral regime not just to internationally active banks (as contemplated by the BIS capital guidelines) but to *all* banks subject to federal regulation.[13]

The guidelines set forth "the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the Committee intend to implement in their respective countries."[14] The basic focus of this multilateral framework was "assessing capital in relation to credit risk (the risk of counterparty failure)."[15] However, the framework acknowledged that "other risks, notably interest rate risk and the investment risk on securities, need[ed] to be taken into account by supervisors in assessing overall capital adequacy."[16] The framework consisted of a minimum required ratio of certain specified constituents of capital to risk-weighted assets. In this context "capital" has two types of constituents:" core

11. Bank for International Settlements, *Final Report for International Convergence of Capital Measurement and Capital Standards*, 4 FED. BANKING L. REP. (CCH) ¶ 47-105 (Mar. 15, 1996) [hereinafter Final Report]. For discussion of the BIS capital adequacy rules and their implementation in U.S. law, see MALLOY, *supra* note 4, § 7.8.

12. *See* Michael P. Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected*, 7 ANN. REV. BANKING L. 75, 75–76, 81–87 (1988) (discussing pre-BIS regulatory practice).

13. *See* 12 C.F.R. pt. 3, app. A, § 1(b)(2) (explaining that the Comptroller's risk-based capital guidelines "apply to all national banks"); *id.* pt. 208, app. A, § I (applying Federal Reserve's risk-based capital guidelines "to all state member banks on a consolidated basis"); *id.* pt. 325, app. A (applying FDIC's risk-based capital maintenance rules "to all FDIC-insured state-chartered banks . . . that are not members of the Federal Reserve System . . . regardless of size").

14. Final Report, *supra* note 11, at 51,166.

15. *Id.* at 51,167.

16. *Id.*

capital;"[17] and "supplementary capital."[18] Core capital, the so-called "Tier 1" of capital elements, consists of equity capital[19] and disclosed reserves from post-tax earnings.[20]

The eligible constituents of Tier 1 and supplementary capital (the so-called "Tier 2" capital) are subject to certain deductions under the framework.[21] The amount of goodwill must be deducted from the figure for Tier 1 capital.[22] The amount of investments in unconsolidated banking and financial subsidiaries, if any,[23] must be deducted from the total capital base.[24] The Committee considered, but ultimately rejected, requiring deduction of banks' holdings of capital issued by other banks or depository institutions.[25] Nevertheless, the framework does reflect the agreement that individual supervisory authorities retain the discretion to require such deductions.[26] If no deduction is applied, such holdings are required to bear an asset risk-weight of 100 percent for purposes of assessing capital adequacy of the holding bank.[27]

The framework endorsed a risk-weighted approach to the assets denominator of the capital-assets ratio.[28] The framework established a relatively simple methodology for risk-weighting, with only five risk weights being employed.[29] Essentially, the methodology effectively captured only credit risk.[30] It left to the discretion of individual supervisory authorities the ability to decide whether to

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17. *See id.* (discussing meaning of "core capital"). *See generally id.* at 51,173, Annex 1 (defining capital in terms of capital base after transitional period).

18. *See id.* at 51,167-51,168 (discussing meaning of "supplementary capital"). *See generally id.* at 51,173, Annex 1 (defining capital in terms of capital base after transitional period).

19. For these purposes, "equity capital" is defined as "[i]ssued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock)." *Id.* at 51,167 n. 2. *See also id.* at 51,174, Annex 1, § D(i) (defining "Tier 1" capital elements). In the case of consolidated accounts, Tier 1 capital would also include minority interests in the equity of subsidiaries of the bank that are less than wholly owned. *Id.*

20. *Id.* at 51,167. For these purposes, disclosed reserves are reserves that are "created or increased by appropriations of retained earnings or other surplus, *e.g.* share premiums, retained profit, general reserves and legal reserves." *Id.* at 51,174. Tier 1 does not include revaluation reserves. *Id.*

21. *Id.* at 51,169.

22. *Id.*

23. The framework generally assumes as the normal practice that subsidiaries will be consolidated for the purpose of assessing capital adequacy, but "[w]here this is not done, deduction is essential to prevent multiple use of the same capital resources in different parts of [a banking] group." *Id.*

24. *Id.*

25. *Id.*

26. *Id.* Conceivably, these discretionary policies may require deduction of the amount of all such holdings, holdings to the extent that they exceed some determined limit in relation to the holding bank's or the issuing bank's capital, or on a case-by-case basis. *Id.* The framework also reflected the agreement that, "in applying these policies, member countries [should] consider that reciprocal cross-holdings of bank capital designed artificially to inflate the capital position of the banks concerned should not be permitted." *Id.*

27. *Id.*

28. *Id.*

29. *See id.* at 51,175-51,176, Annex 2 (establishing risk weights by categories of on-balance-sheet asset).

30. *Id.* at 51,169.

attempt to account for more methodologically difficult types of risk, such as investment risk, interest rate risk, exchange rate risk or concentration risk.[31] Furthermore, the individual supervisory authorities also retained discretion to supplement the framework's risk-weighted methodology with "other methods of capital measurement,"[32] such as the mandated capital-assets ratios previously established by individual national regulators. To account for country transfer risk, the Committee adopted an approach that applied differing risk-weights to defined groups of countries.[33]

The framework also recognized the importance of bringing off-balance-sheet risk into the analysis of capital adequacy.[34] All categories of off-balance-sheet risk were brought within the framework, by conversion into appropriate credit risk equivalents.[35]

Uncertainty remained regarding the appropriate approach to items exposed to significant interest-rate and exchange-rate related risk, such as swaps, options and futures.[36] As to these contingencies, the framework took the position that special treatment was necessary, "because banks are not exposed to credit risk for the full face value of their contracts, but only to the cost of replacing the cash flow if the counterparty defaults."[37]

Once the credit equivalent amounts of such contingencies have been calculated, the amounts are to be weighted in accordance with the risk weights

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31. *Id.* at 51,169-51,170.
32. *Id.* at 51,169.
33. *Id.* at 51,170-51,171:

> [T]he Committee has concluded that a defined group of countries should be adopted as the basis for applying differential weighting coefficients[.] The framework also recognizes the importance of and that this group should be full members of the OECD or countries which have concluded special arrangements with the [International Monetary Fund] associated with the Fund's General Arrangements to Borrow. . . .
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> This decision has the following consequences for the weighting structure. Claims on central governments within the OECD will attract a zero weight (or a low weight if the national supervisory authority elects to incorporate interest rate risk); and claims on OECD non-central government public-sector entities will attract a low weight. . . . Claims on central governments and central banks outside the OECD will also attract a zero weight (or a low weight if the national supervisory authority elects to incorporate investment risk), provided such claims are denominated in the national currency and funded by liabilities in the same currency. . . .
>
> As regards the treatment of interbank claims, in order to preserve the efficiency and liquidity of the international interbank market[,] there will be no differentiation between short- term claims on banks incorporated within or outside the OECD. However, the Committee draws a distinction between . . . short-term placements with other banks . . . and . . . longer-term cross-border loans to banks which are often associated with particular transactions and carry greater transfer and/or credit risks. A 20 per cent [*sic*] weight will therefore be applied to claims on all banks, wherever incorporated, with a residual maturity of up to an[d] including one year; longer-term claims on OECD incorporated banks will be weighted at 20 per cent [*sic*]; and longer-term claims on banks incorporated outside the OECD will be weighted at 100 percent.

34. *See id.* at 51,171-51,172 (discussing treatment of off-balance-sheet engagements).
35. *See id.* at 51,176, Annex 3 (establishing credit conversion factors for off-balance-sheet items).
36. *Id.* at 51,172.
37. *Id.*

applicable to the category of counterparties involved. However, in anticipation of the fact that most counterparties in the market for such contingencies, particularly long-term contracts, "tend to be first-class names,"[38] the Final Report reflected general agreement that such contingencies would be assigned a 50 percent risk weight, rather than the 100 percent risk weight that might otherwise be applicable.[39]

The final element in the risk-weighted methodology, as with any capital-assets ratio requirement, is the required minimum level of the ratio. As the proposed version of this multilateral agreement was taking shape, it was generally agreed that specifying a target ratio was desirable before the proposed framework was circulated at the national level for consultation and discussion. After further consultations and study of the proposed version, the framework adopted a target standard ratio of eight percent, of which core capital must constitute at least four percent.[40] This target ratio became fully applicable at year-end 1992.[41]

The Basel Committee has continued to refine the details and mechanics of risk management and supervision.[42] Correspondingly, implementation of the guidelines in the United States has not been a static project; the guidelines have been the subject of almost continuous reassessment and refinement by the regulators.[43] By the mid-1990s, the agencies were seriously focusing upon

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38. *Id.* at 51,178.

39. *Id.* However, some member countries have apparently reserved the right to apply the full 100 percent risk weight. *Id.* n. 9.

40. *Id.* at 51,172.

41. *Id.* at 51,172-51,173.

42. *See, e.g.*, BANK FOR INTERNATIONAL SETTLEMENTS ("BIS"), COMMITTEE ON BANKING SUPERVISION, THE TREATMENT OF THE CREDIT RISK ASSOCIATED WITH CERTAIN OFF-BALANCE-SHEET ITEMS (1994); BIS, COMMITTEE ON BANKING SUPERVISION, RISK MANAGEMENT GUIDELINES FOR DERIVATIVES (1994); BIS, COMMITTEE ON BANKING SUPERVISION, AMENDMENT TO THE CAPITAL ACCORD OF JULY 1988 (1994); BIS, COMMITTEE ON BANKING SUPERVISION, PRUDENTIAL SUPERVISION OF BANKS' DERIVATIVES ACTIVITIES (1994); BIS, COMMITTEE ON BANKING SUPERVISION, BASEL CAPITAL ACCORD: TREATMENT OF POTENTIAL EXPOSURE FOR OFF-BALANCE-SHEET ITEMS (1995); BIS, COMMITTEE ON BANKING SUPERVISION, AN INTERNAL MODEL-BASED APPROACH TO MARKET RISK CAPITAL REQUIREMENTS (1995); BIS, COMMITTEE ON BANKING SUPERVISION, PUBLIC DISCLOSURE OF THE TRADING AND DERIVATIVES ACTIVITIES OF BANKS AND SECURITIES FIRMS (1995); BIS, COMMITTEE ON BANKING SUPERVISION, SUPERVISORY FRAMEWORK FOR THE USE OF "BACKTESTING" IN CONJUNCTION WITH THE INTERNAL MODELS APPROACH TO MARKET RISK CAPITAL REQUIREMENTS (JAN. 1996); BIS, COMMITTEE ON BANKING SUPERVISION, AMENDMENT TO THE BASEL CAPITAL ACCORD TO INCORPORATE MARKET RISKS (1996); BIS, COMMITTEE ON BANKING SUPERVISION, INTERPRETATION OF THE CAPITAL ACCORD FOR THE MULTILATERAL NETTING OF FORWARD VALUE FOREIGN EXCHANGE TRANSACTIONS (1996); BIS, COMMITTEE ON BANKING SUPERVISION, PRINCIPLES FOR THE MANAGEMENT AND SUPERVISION OF INTEREST RATE RISK (2001). Most recently, the Basel Committee has asked for comment, by October 31, 2003, on revised interest rate risk principles as part of its larger work on developing new international bank capital standards. *Basel Committee Asks for Comment On Revised Interest Rate Risk Principles*, BNA Banking Daily, Sept. 8, 2003, *available at* http://www. bis.org/publ/bcbs102.htm (providing the revised consultative paper and a summary explanation concerning the new proposal).

43. *See, e.g.*, 62 Fed. Reg. 55,686 (1997) (to be codified at 12 C.F.R. pts. 3, 208, 325, 567) (proposing uniform treatment of certain construction, real estate loans and investments in mutual funds; simplifying Tier 1 capital standards); 62 Fed. Reg. 55,692 (1997) (to be codified at 12 C.F.R. pt. 225) (proposing similar

management of interest-rate risk, which was not within the purview of the original guidelines.[44] Similarly, the regulators have folded market-risk provisions into the framework of the guidelines.[45]

II. BASEL II

A. *Objectives and General Framework*

The capital adequacy methodology exhibited some serious shortcomings. First, the framework primarily recognized only a narrow, though very significant, type of risk–credit risk, i.e., the risk of counterparty failure.[46] Over time, the methodology was refined to fold in other types of risk; namely interest-rate risk and exchange-rate risk.[47] Nevertheless, there was still no calibration within the methodology for internal or "operational" risk[48] broadly speaking, the risks

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amendments with respect to treatment of capital of bank holding companies); 62 Fed. Reg. 59,944 (1997) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 567) (proposing regulatory capital treatment of recourse obligations and direct credit substitutes); 64 Fed. Reg. 10,194 (1999) (codified at 12 C.F.R. pts. 3, 208, 325, 567) (OCC, Fed, FDIC and OTS rules for construction loans on pre-sold residential properties, junior liens on one- to four-family residential properties, investments in mutual funds, and Tier 1 leverage ratio); 64 Fed. Reg. 10,201 (1999) (codified at 12 C.F.R. pt. 225) (corresponding Fed rule applicable to bank holding companies); 65 Fed. Reg. 12,320 (2000) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 567) (proposing changes in risk-based capital standards to address recourse obligations and direct credit substitutes); 65 Fed. Reg. 16,480 (2000) (to be codified at 12 C.F.R. pt. 225, Appendices A, D) (proposing regulatory capital treatment of certain investments in nonfinancial companies by bank holding companies); 67 Fed. Reg. 16,971 (2002), *corrected*, 67 Fed. Reg. 34,991 (2002) (codified at 12 C.F.R. pts. 3, 208, 225, 325, 567) (reducing risk-weight applicable to claims on, and claims guaranteed by, qualifying U.S. securities firms and securities firms incorporated in OECD member countries from 100 percent to 20 percent; conforming FDIC and OTS rules to existing OCC and Fed to permit zero percent risk weight for certain claims on qualifying securities firms collateralized by cash on deposit in lending institution or by securities issued or guaranteed by the United States or other OECD central governments); 68 Fed. Reg. 56,530 (2003) (codified at 12 C.F.R. pt. 3, app. A, pt.208, app. A, pt.225, app. A, pt. 325, app. A, §§ 567.1, 567.5(a)(1)(iii), 567.6(a)((3)-(4)) (issuing interim final rule to remove consolidated asset-backed commercial paper program assets from risk-weighted asset bases for purpose of calculating risk-based capital ratios).

44. *See, e.g.*, 61 Fed. Reg. 33,166 (1996) (publishing OCC, FRS & FDIC joint policy statement providing guidance on sound practices for managing interest rate risk). *But see* 67 Fed. Reg. 31,722 (2002) (codified at 12 C.F.R. §§ 516.40(a)(2), 567.1, 567.5(b)(4), 567.6(a)(1)(iv)(G)-(H); *removing* § 567.7) (imposing 50 percent risk weight for certain qualifying mortgage loans; eliminating interest rate risk component of risk-based capital regulations; making technical amendments).

45. *See, e.g.*, 62 Fed. Reg. 68,064 (1997) (codified at 12 C.F.R. pts. 3, 208, 225, 325) (amending market risk provisions in risk-based capital standards).

46. For extensive discussion of the types of risk relevant to the conduct of the business of banking, see *Core Principles*, *supra* note 10, § IV.A.

47. *See, e.g.*, *supra* note 43 (citing revisions in methodology to account for interest rate and exchange rate risks).

48. The term *operational risk* may be defined as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events." BIS, COMMITTEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: THE NEW CAPITAL ACCORD 94 (2001) [hereinafter *Accord*]. As used in the BIS proposed Accord, the term does not include strategic and reputational risk. *Id.* For discussion of reputational risk, see *Core Principles, supra* note 10, at 291. A working paper of the BIS Committee's Risk Management Group has proposed the deletion of the phrase "direct or indirect" from the definition of operational loss, because it was too vague. RISK MANAGEMENT GROUP, BIS COMMITTEE ON BANKING SUPERVISION, WORKING PAPER ON THE REGULATORY TREATMENT OF OPERATIONAL RISK, *available*

attendant upon poor management of asset risks, yet surely this type of risk was important for safety and soundness purposes.

Second, the methodology for risk-weighting was technically rudimentary. Five basic risk weights—0, 10, 20, 50 and 100 percent of asset value—were available for *all* types of assets and *all* types of counterparties. This arrangement produced such anomalous results as the application of the same risk-weight to a commercial loan to a small business operating a local retail computer store and a commercial loan to a major dot.com corporation, despite the obvious differences in the relative risks involved in the two borrowers.

Third, the framework did not take into account the dramatic changes in the contours of the banking market itself. These changes included consolidation in holding company patterns of ownership and control of increasingly diversified financial services enterprises. Consolidation and diversification were taking place in a markedly more globalized market environment.

Fourth, the methodology tended to be insensitive to the individual experience and operational qualities of banks. The framework had one size to fit all banks subject to capital adequacy requirements.[49] Thus, greater reliance on standardized capital adequacy calculations—a tendency clearly exhibited by U.S. statutes–carried with it the danger that there would be less emphasis on individualized safety-and-soundness assessment of particular banks.

Over the past decade, the BIS Committee began working on amendments to the 1988 Guidelines in order to take account of new globalized financial practices and to create a more flexible, risk-sensitive framework for determining minimum capital requirements.[50] In June 1999, the BIS issued a proposal that would significantly revise the capital adequacy accord[51] in two basic ways: by extensively refining the 1988 guidelines and by providing a dramatic alternative approach. The new approach had three basic principles: (i) international banks would be required to establish their own internal methods for assessing the relative risks of their assets; (ii) supervisory authorities would be expected to exercise greater oversight of these capital assessments; and (iii) greater transparency in banking operations would be required, e.g., the creditworthiness of borrowing governments and corporations would be assessed by credit-rating

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at http://www.bis.org [hereinafter *RMG Working Paper*]. In June of 2002, the Basel Committee announced that it would be seeking detailed information from internationally active banks with respect to operational risk exposures for 2001. Daniel Pruzin, *Basel Committee Seeks More Bank Data on Operational Risk Exposures for FY 2001*, BNA INT'L BUS. & FIN. DAILY, June 7, 2002, at d7.

49. This was particularly true of the U.S. application of the BIS framework. While the framework by its own terms applied only to international banks, U.S. statutes and implementing regulations applied the capital adequacy regime to *all* banks subject to federal regulation. *See supra* note 13 and accompanying text (discussing scope of U.S. capital adequacy rules).

50. *See* Daniel Pruzin, *Basel Committee Sets Out Changes to Risk Calculations Under Capital Accord*, BNA Int'l Bus. & Fin. Daily, Oct. 3, 2001, at d3 (discussing BIS motivations for proposed Capital Accord). *See also supra* note 42 (citing BIS issuances concerning refinement of capital adequacy framework).

51. *See, e.g.*, Alan Cowell, *An International Banking Panel Proposes Ways to Limit Risk*, N.Y. TIMES, June 4, 1999, at C4 (describing proposed revision).

agencies, and these ratings would be used by banks in pricing loans to such borrowers. Financial institutions had until March 31, 2000 to respond to the proposed revisions, which the BIS anticipated would be effective no sooner than 2001.[52]

B. Analysis of Specific Features of the Proposal

A revised version of the proposal was issued for comment in January 2001.[53] This version adopted a three-pronged approach to capital adequacy for international banks that were qualified to use it: capital adequacy requirements (largely revised from the 1988 guidelines);[54] increased supervision of bank capital maintenance policies;[55] and greater transparency through disclosure to the market, with resulting market discipline.[56] These elements are referred to as the three "pillars" of minimum capital requirements, the supervisory review process, and market discipline.

Of the three pillars, by far the most extensively discussed in the proposal was the first pillar, which would involve significant changes in capital adequacy regulation. First, capital requirements would be extensively revised from the original framework version and would offer banks two alternative approaches to capital adequacy. The standardized approach[57] would be essentially the 1988 guidelines, as revised by the new Accord.[58] The revisions represented refinements of the guidelines, including for example more articulated risk weights with respect to claims on sovereign borrowers based upon their credit assessments by export credit agencies.[59] Furthermore, the Accord would impose a requirement that internationally active banks account for operational risk (arising from poor documentation, fraud, infrastructural failure and the like),[60] in addition to credit and market risk.[61] Generally, the charge for operational risk would involve approximately 20 percent of overall capital requirements.[62] The capital requirements would be applied to consolidated and sub-consolidated elements of larger financial services enterprises.[63]

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52. *Id.* at C4.
53. *Accord, supra* note 48.
54. *See Accord* at 6-103 (discussing approaches to capital requirements).
55. *See id.* at 104-112 (discussing supervision).
56. *See id.* at 114-133.
57. *Id.* at 7-31.
58. *Id.* at 7.
59. *Id.* at 7-8.
60. *See supra* notes 46-48 and accompanying text (discussing operational risk).
61. *Accord, supra* note 48, at 95.
62. *Id.* at 95 n.51.
63. *Id.* at 1:

> 1. The New Basel Capital Accord . . . will be applied on a consolidated basis to internationally active banks. . . .

As an alternative to the standardized approach, banks that could demonstrate to their supervisors an internal methodology for assigning exposures to different classes of assets consistently over time[64] would be able to maintain capital in accordance with an internal credit ratings system (the so called "internal ratings based," or "IRB" approach).[65] The IRB approach was based upon sophisticated computer modeling or other in-house analytical tools to determine credit risk on a borrower-by-borrower basis that included an estimate of future losses on assets.[66] Two methodologies were available in this regard. The foundation methodology would allow the bank to estimate internally the probability of default on the asset, while using regulator-imposed analysis of other risk components associated with the asset.[67] Under the advanced methodology, a sophisticated bank would be permitted to use internally generated estimates for other risk components.[68]

C. Likely Effects

In its proposed version, the new Accord was highly criticized by banking industry commentators,[69] mainly because reporting requirements were perceived as excessive and the level of capital charges were viewed as unnecessarily high. In addition, in the Spring of 2001, the annual report of the Basel Committee, reviewing the public disclosure practices of international banks, criticized the relative lack of disclosure in areas related to credit risk modeling and use of internal and external ratings by major banks.[70] This seriously implicated the proposed Accord since disclosure of information with respect to the use of

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2. The scope of application of the Accord will be extended to include, on a fully consolidated basis, holding companies that are parents of banking groups to ensure that it captures risks within the whole banking group. . . .
3. The Accord will also apply to all internationally active banks at every tier within a banking group. . . .

(Footnote omitted.) However, the parent holding company of a banking group's holding company may not itself be subject to the Accord if it is not viewed as a parent of a banking group. *Id.* at 1.

64. *Accord, supra* note 48, at 32.

65. *Id.* at 32-86.

66. *Id.* at 34.

67. *Id.* In October 2001, a task force of the BIS Committee questioned whether the foundation approach was necessary and asked for comment from the banking industry on this issue. MODELS TASK FORCE, BIS COMMITTEE ON BANKING SUPERVISION (Working Paper on the Internal Ratings-Based Approach to Specialized Lending Exposures), *available at*, http://www.bis.org [hereinafter *MTF Working Paper*].

68. *Accord, supra* note 48, at 34.

69. *See* Pruzin, *supra* note 50, at d3 (noting industry opposition).

70. Daniel Pruzin, *Basel Committee Cites Mixed Results for Meeting Proposed Capital Accord*, BNA INT'L BUS. & FIN. DAILY, Apr. 24, 2001, at d2. However, in a May 2002 report, the Basel Committee indicated that internationally active banks had modestly increased their public disclosure of such information during 2000. Daniel Pruzin, *Basel Committee Cites "Modest" Improvement in Information Disclosures*, BNA INT'L BUS. & FIN. DAILY, May 16, 2002, at d5. Nevertheless, it did caution that most banks still failed to provide such information with respect to the use of credit derivatives and other sophisticated instruments subject to reporting requirements under the proposed accord. *Id.*

internal ratings is necessary for banks to qualify for the IRB approach proposed in "Pillar 1" of the new accord.[71]

In fact, as a result of the critical comments that were received in response to the last version of the proposal, and the need for further study and adjustment of the proposal in light of those comments, in June 2001 the BIS Committee decided to delay implementation of the proposed Capital Accord until 2005.[72] The delay was particularly welcomed by the European Commission, which had launched a consultative process for a parallel EU proposal based on the Basel Committee's recommendations.[73] The Commission noted that, during its own consultation process, the proposed calibration of risk weights and the potential impact of the proposed ratio of regulatory capital to operational risk (a ratio of twenty percent) had been consistently criticized by various sectors of the banking and financial services industry.[74] Concerns had also been raised about the relatively tight timetable for finalizing the new capital regime.[75]

In a working paper issued September 28, 2001, the Risk Management Group of the BIS Committee on Banking Supervision outlined changes to the proposed Capital Accord.[76] The proposed changes to "Pillar 1" of the Accord would include, inter alia, a significant lowering of the operational risk charge as a percentage of a bank's overall capital set-aside requirements and greater flexibility in the use of advanced internal risk estimate methods for determining a bank's minimum capital requirements.[77] Comments on the proposed changes were to be received by October 31, 2001.[78]

On October 5, 2001, the BIS Committee released another working paper, proposing further changes to the revised Accord.[79] The working paper focused on issues concerning the application of IRB approaches to risk assessment, and specifically on the treatment of "specialized loans" such as project finance undertakings.[80] The working paper proposed a specific framework for treatment of specialized loans that relied upon a stream of income generated by an asset rather than the creditworthiness of the borrower for repayment of the loan. Such a loan arrangement does not conform to assumptions underlying the IRB approach

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71. Pruzin, *Basel Committee Cites Mixed Results, supra* note 70.

72. Daniel Pruzin, *Capital Accord Draft Completion Delayed as Basel Committee Eyes New Revisions*, BNA INT'L BUS. & FIN. DAILY, June 26, 2001, at d3.

73. Joe Kirwin, *EC Welcomes Basel Committee Delay in Implementing New Capital Accord*, BNA BANKING DAILY, June 26, 2001, at d3.

74. *Id.*

75. *Id.*

76. *RMG Working Paper, supra* note 48. *See* Pruzin, *supra* note 50, at d3 (reporting on implications of *RMG Working Paper*).

77. *See* Pruzin, *supra* note 50, at d3 (discussing proposed changes).

78. *Id.*

79. *MTF Working Paper, supra* note 67. *See* Daniel Pruzin, *Basel Committee Outlines Further Changes to IRB Approach in Proposed Capital Accord*, INT'L BUS. & FIN. DAILY, Oct. 10, 2001, at d5 (reporting on *MTF Working Paper*).

80. *MTF Working Paper, supra* note 48.

of the revised Accord, which tends to focus on the ongoing operations of the borrower as the source of repayment.[81] The proposed treatment of specialized loans would include any loans that exhibited the following characteristics: (i) the loan is intended for the acquisition or financing of an asset; (ii) an asset cash flow is the sole or almost sole source of repayment; (iii) the loan represents a significant liability for the borrower; and (iv) the key determinant of credit risk is the existence of variability of asset cash flow, rather than the independent creditworthiness of the borrower's overall enterprise.[82] According to the MTF Working Paper, four loan products clearly met these criteria: project finance,[83] income-producing real estate, big-ticket lease financing (or "object financing"), and commodity financing. These and possibly other loan products would be subject to a single framework, with a specified set of components generating minimum capital requirements related to the specialized loan products.

In December 2001, the BIS Committee announced that it had decided to carry out a comprehensive quantitative impact study ("QIS") immediately, to assess the overall impact of the proposed capital accord on banks and the banking system.[84] The revised version of the Accord, which the Committee had planned to circulate in early 2002, has been postponed indefinitely.[85] This development raised doubts as to whether the new Accord would be finalized during 2002 and implemented by 2005.[86]

In fact, as controversy and criticism continued to build with respect to Basel II, it was not until July 2003 that the Federal Reserve and the Federal Deposit Insurance Corporation even scheduled discussion of a joint advance notice of proposed rulemaking with respect to the proposal.[87] Prospects for reaching consensus on such an implementing rule remain very much in doubt both because of the complexity of Basel II itself and because of the diverging and conflicting interests that need to be reconciled by the Basel Committee and by home country regulators.[88]

The momentum behind the Basel II continued to dissipate. In April 2003, the Basel Committee asked for comment on its "Third Consultative Paper of the New

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81. *See, e.g., Accord, supra* note 79, at 50-51 (discussing risk assessment criteria applicable to corporate exposures).

82. Pruzin, *supra* note 79, at d5.

83. The MTF understood project finance to include specialized lending transactions ("in which the lender looks primarily to the revenues generated by a single project") for security and repayment. *MTF Working Paper, supra* note 67. For discussion of project finance and other specialized forms of lending, see Michael P. Malloy, *International Project Finance: Risk Analysis and Regulatory Concerns,* 18 TRANSNAT'L LAW. 89 (2004).

84. Daniel Pruzin, *Basel Committee Announces Further Delay to Completion of Revised Capital Accord,* INT'L BUS. & FIN. DAILY, Dec. 14, 2001, at d9.

85. *Id.*

86. *Id.* (quoting statement issued by the Committee).

87. Richard Cowden, *FDIC, Fed Schedule July 11 Discussion Of ANPR for Basel II Capital Accord Plan,* BNA BANKING DAILY, July 8, 2003.

88. *Id.* at 1.

Basel Capital Accord" and indicated its intention to finalize in the near future a Basel II Accord that would be implemented in 2007.[89] In August 2003, the British Bankers' Association and the London Investments Banking Association confirmed that they had requested a delay in Basel II until 2010, and expressed a desire that the Basel II rules be further revised to be "less prescriptive and more principles-based."[90] Towards the end of that month, Standard & Poor's Rating Service ("S&P") announced that it might downgrade banks if it disagreed with methods the banks used under Basel II to calculate capital requirements.[91] Although S&P expressed support for the Basel II effort to improve bank sensitivity to risk and risk assessment and measurement, "changes in the availability of credit arising from incentives created by the accord could have far-reaching effects on bank funding, the continued development of international capital markets, and the global economy."[92]

The BIS appears to have emerged from this institutional crisis of confidence with its reputation more or less intact. In May 2004, the Committee announced that it had reached agreement on outstanding issues that had impeded the finalizing of the Basel II Accord.[93] The Committee stated that it would adhere to a proposed year-end 2006 target date for banks to adopt the more basic "standardized" and "foundation IRB" approaches for assessing minimum capital charges.[94] However, for banks adopting the most advanced Internal Ratings-Based ("IRB") approaches–which includes most, if not all major internationally-active banks, the Committee expected that a year-end 2007 target date was necessary to allow further impact analysis and parallel running before full implementation.[95]

In June 2004, the Committee approved the final version of the revised Accord.[96] The Committee emphasized that it would continue to review the calibration of the accord prior to its implementation and adjust it as necessary to

89. R. Christian Bruce, *Regulators Must Supply More Answers Before Basel Can Be Adopted, Shelby, Sarbanes Say*, BNA BANKING DAILY, June 19, 2003, at 1.

90. Patrick Tracey and Karen Werner, *British Banking Groups Seek Delay In Basel II Capital Accord Until 2010*, BNA BANKING DAILY, Aug. 11, 2003, at 1. The detailed response of the two associations to the latest version of Basel II is available at http://www.bba.org.uk/pdf/144112.pdf

91. Richard Cowden, *S&P Report Says It Might Downgrade Banks Some Banks Under Basel II Rules*, BNA BANKING DAILY, Aug. 28, 2003. The Standard & Poor's report on Basel II is available at http://www.standardandpoors.com.

92. Cowden, *S&P Report*, *supra* note 91, at 1 (quoting Barbara Ridpath, Managing Director and Chief Criteria Officer, Standard & Poor's Europe).

93. Daniel Pruzin, *Basel Committee Announces Deal On Key Remaining Accord Issues*, BNA BANKING DAILY, May 12, 2004. These issues included calibration of minimum capital requirements, the proposed capital charge for operational risk, and the use of advanced internal ratings-based ("IRB") systems for assessing bank capital charges. *Id.*

94. *Id.*

95. *Id.*

96. COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004), *available at* http://www.bis.org/publ/bcbs107.htm.

ensure that the new capital rules did not result in a sharp increase in overall minimum capital requirements.[97] As with the previous guidelines, the Committee expected that the revised Accord would become the global standard for minimum capital requirements.[98] However, India and China, among other major developing countries, have already indicated that they did not intend to adopt the revised accord,[99] and U.S. regulators—including the Securities and Exchange Commission ("SEC") as well as the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve Board (the "Fed"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of Thrift Supervision ("OTS")—have decided that it will only be required for the relatively small number of the largest internationally-active U.S. banks.[100]

Basel II would certainly seem to address many of the shortcomings observed in the current capital guidelines.[101] The proposal recognizes a much wider spectrum of risk, going well beyond the risk of counterparty failure to include even operational risk as a component in the calculation of capital adequacy requirements. It involves a relatively more articulated methodology for weighing the risks of specific types of assets, possibly even including specialized loan products with their own risk assessment methodology. It also addresses the marked changes in the nature of the international banking market since the emergence of the framework in 1988, as in its elaborate rules with respect to consolidation and subconsolidation in holding company patterns of ownership and control of complex, diversified financial services enterprises. Finally, it also appears more risk-sensitive because of its resort to individualized treatment of sophisticated banking enterprises, which is exemplified by its provisions for IRB assessment of asset risks.

One fundamental question is still unresolved. Why use capital as the basic measuring tool of safety and soundness in banking supervision? In traditional corporate law terms, capital serves at least four distinct roles, among others. First, capital is the source of the primary (or, at least, the most significant) operational financial resources for the corporate enterprise. Second, it is the marker for the competing property interests in the enterprise, indicating the ultimate (i.e., liquidational) property rights of various classes of investors. Third, capital serves as a marker for associational rights and obligations, indicating, for example, the relative voting rights of different classes of investors. Fourth, capital is the primary measure or precondition of insolvency.

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97. Daniel Pruzin, *Basel Committee Approves 'Final' Version of Capital Accord; Criteria Could Still 'Evolve'*, BNA BANKING DAILY, June 29, 2004.

98. *Id.*

99. *Id.*

100. *Five Federal Agencies Announce Plans to Implement Basel II over Four-year Period*, BNA BANKING DAILY, June 29, 2004.

101. *See supra* notes 46-49 and accompanying text (discussing shortcomings of BIS guidelines).

The problem is that banking enterprises tend to be atypical and asymmetrical with respect to the corporate roles of capital. This is particularly true of the first and fourth roles of capital just identified. On the other hand, in sharp contrast with the pattern found in most modern general business corporation statutes, banking statutes add an additional role for capital—that of gatekeeper to the industry. In this sense, minimum capital requirements and rules about continuing capital maintenance, long abandoned as formal requirements for incorporation under general business corporation statutes, continue to hold sway in the regulated industry of banking. This fifth role may help to explain why in both national banking statutes and in the BIS guidelines and proposed Accord, capital is treated as a central focus of supervisory policy. Is this emphasis warranted as a matter of fact?

Early in the last century, in *Texas & Pacific Ry. v. Pottorff*,[102] U.S. Supreme Court Justice Brandeis observed: "The amount of the deposits is commonly accepted as a measure of the bank's success; and increase of deposits as evidence of increased prosperity." Thus, banks are exceptionally adept at using other people's money, rather than their own capital, as the primary source of operational resources. It is the bank deposit, a debt arrangement, that serves to generate the primary bank assets (loans, investments and the like), not a bank's capital. In fact, banks are among the most highly leveraged of commercial enterprises.

Of course, it may be argued that supervisory attention to capital requirements imposes market discipline on banks, and that this discipline will significantly supplement safety and soundness in banking. This argument remains largely undemonstrated in empirical terms. Given the highly leveraged condition of banks, it is likely that the market would in most instances exercise relatively trivial disciplinary pressure. Furthermore, the capital market is the wrong market exercising the discipline; depositors, the major "investors" in these enterprises, tend to refrain from exercising discipline until it is too late.[103]

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102. 291 U.S. 245 (1934), *amended by* 291 U.S. 649 (1934), *reh'g den'd*, 292 U.S. 600 (1934).

103. Some commentators have suggested that complete deregulation-and governance by market forces represent the correct approach to bank regulatory policy in this regard. *See, e.g.*, Macey & Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. REG. 215 (1988) (arguing for increased reliance on market discipline by depositors). Market discipline presupposes that investors (and quasi-investors like depositors) can, and would, influence the choice of risk-generating activities of banks by their investment decisions. The assessment of the expected returned and potential investment risk by prospective or current investors might affect an institution's decisions by increasing the expected return offered (thus increasing the cost of relatively risky activities), or by decreasing the potential risk. There are at least two problems with this approach, however. First, as an empirical matter, depositors do not generally contract with depository institutions with the mindset or motivations of investors—nor is it clear that they should. *See* Garten, *Banking on the Market: Relying On Depositors to Control Bank Risks*, 4 YALE J. REG. 129 (1986) (arguing that the market discipline approach to bank regulation is unlikely to work in practice, given the behavior of depositors); Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 YALE J. REG. 241 (1988) (criticizing market discipline arguments of Macey & Garrett); Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501, 558-64 (1989) (discussing increased attention to the "market discipline" approach to bank regulation). Second, public

Capital requirements might serve as a tripwire to alert bank and regulator alike to serious problems in a bank's operations. This argument also remains undemonstrated as an empirical matter. Even if true, this is at most a *post hoc* alarm system, particularly when speaking of operational risk. Conceivably, more market-sensitive tripwires would make more sense: possibly the oversight of market performance of subordinated debt—another major component of a bank's capital structure. However, the volatility of that market may make the trip-wire very accurate but untimely.

III. IMPLICATIONS FOR INTERNATIONAL LAW

A. *General Sources of International Law*

It is a commonplace notion that binding legal principles in public international law derive from a specific range of recognized sources.[104] The primary source is the body of customary principles of international law, derived from the common practice of states undertaken because of the perceived binding nature of the practice (*opinio juris*).[105] The second source is treaty law—legal principles derived from conventional practice. A third, more elusive source is the body of general principles of law recognized by civilized states. A fourth and final source, much beloved by academics, consists of the writings of recognized publicists. It would be very difficult to find a place for the issuances and undertakings of the BIS in this array of sources.

B. *The Legal Character of BIS Issuances*

The BIS itself has consistently taken the position that Basel Committee issuances are not sources of law. Thus, it states on its website:

> The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the

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disclosure is *already* one instrument of regulation, and its proper role is open to question. *See* Malloy, *Public Disclosure as a Tool of Federal Bank Regulation*, 9 ANN. REV. BANKING L. 229 (1990) (discussing and criticizing current uses of public disclosure in bank regulation). Indeed, the use of public disclosure in banking regulation has created additional ambiguity in the regulatory system, because the system is still essentially committed to a confidential approach to supervision and enforcement. *See, e.g.*, Mathewson, *From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks*, 11 J. CORP. L. 139, 146-50 (1986) (discussing development of "confidential supervision" as basic principle of federal bank regulation).

104. *See, e.g.*, International Court of Justice Statute, art. 38, ¶ 1 (identifying sources of law).

105. For a useful example of the establishment of a principle of customary international law, see North Sea Continental Shelf Cases (Federal Republic of Germany v. Denmark; Federal Republic of Germany v. Netherlands), 1969 I.C.J. 3.

> 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.[106]

This position is reflected in the specific language of BIS issuances, particularly and most emphatically in the Basel Concordat. The Concordat is not, by its own terms, a binding international treaty or agreement. It is at best a statement of principles. The Concordat purports to set forth the optimal operating principles endorsed by the members of the Committee. Post-Concordat issuances of the BIS with respect to supervision of multinational banking enterprises, such as the April 1990 Supplement to the Concordat or the June 1992 Report on Minimum Standards, do not affect the character or basic framework established of the Concordat in this regard.

The principles identified in the 1992 Report are considered "standards," but they are not, on their own explicit terms, binding on states. Nevertheless, the Report also makes it clear that BIS participating states are expected to implement the standards, and other states are encouraged to do so—the fourth "standard" seems to establish a right in participating states to exclude banking enterprises from states that do not endorse the standards. Indeed, in U.S. practice the fourth standard has been implemented as a statutory expectation and requires that a non-U.S. based banking enterprise applying for entry will be subject to comprehensive supervision by its home state as a condition of entry into the U.S. market.[107]

While the BIS has been consistently careful to refrain from asserting source-of-law status for the issuances of the Basel Committee, products like the 1988 Capital Accord and the proposed Basel II do not express themselves in mere precatory language, but in prescriptive terms. More importantly, states have endorsed the specific principles of the Accord as legally binding features of their national regulatory systems, and the states—and affected private sectors–have treated the development of Basel II as legally significant. One might argue that the administrative *process* of rule-creation performed by the Basel Committee is itself a source of international regulatory law, intended to be implemented and enforced by adoption in individual national regulatory systems. It remains then, to examine the behavior of states and other interested parties in this regard.

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106. BIS, THE BASEL COMMITTEE ON BANKING SUPERVISION, *at* http://www.bis.org/bcbs/aboutbcbs.htm.

107. *See, e.g.*, 12 U.S.C. § 3105(d)(2)(1)(A) (applying the "comprehensive supervision" rule to branch entry).

C. Behavior of States

Recognition of the untraditional character of this process of rule-creation should not be blunted by a narrow allegiance to traditional categories of sources of law under public international law. Contemporary behavior of states with respect to bank regulatory rules and practices suggests that certain issuances of the Basel Committee are in fact accorded source-of-law recognition. As the BIS itself has acknowledged, "[i]n many cases, supervisory authorities in non-G-10 countries have seen fit publicly to associate themselves with the Committee's initiatives."[108] The 1988 Capital Accord is currently used by regulators in over 100 countries to determine minimum capital reserves of banks subject to their supervision.[109]

Nothing illustrates the law-like character of the Basel II proposal more clearly than the reaction of interested states—and banking constituencies within these states—to the details of Basel II in its proposed form. Since U.S. law applies the 1988 Capital Accord to *all* depository institutions, adoption of Basel II would pose particularly difficult regulatory issues concerning disparate treatment. It has been estimated that the ten largest U.S. banks would adopt the more flexible IRB approach to capital adequacy, with perhaps the next largest ten to twenty banks also permitted to do so.[110] The remaining thousands of depository institutions would continue to be subject to the more restrictive regime of the 1988 Capital Accord. Members of the Senate Banking Committee have raised critical questions about this dichotomy in treatment under Basel II.[111] For example, would lower capital costs for the largest twenty to thirty U.S. banks create an unjustifiable competitive disadvantage for large regional banks and smaller "community" banks? Could this situation result in a renewed wave of acquisitions, eliminating smaller banks that service local communities? Furthermore, competitive issues aside, does Basel II give too much discretion to the largest banks to formulate the specific capital requirements that will apply to them?

In May 2003, a bill entitled the United States Financial Policy Committee For Fair Capital Standards Act[112] was introduced to establish a formal mechanism for developing uniform U.S. positions on issues before the Basel Committee, and to require a review of the most recent proposals of the Committee on Basel II. The House Financial Institutions and Consumer Credit Subcommittee approved the bill and recommended it to the full House Financial Services Committee on

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108. BIS, THE BASEL COMMITTEE, *supra* note 106.

109. Daniel Pruzin, *Basel Committee Cites Mixed Results for Meeting Proposed Capital Accord*, BNA INT'L BUS. & FIN. DAILY, Apr. 24, 2001, at d2.

110. R. Christian Bruce, *Regulators Must Supply More Answers*, *supra* note 89, at 1.

111. *See id.* at 1-2 (discussing issues raised).

112. H.R. 2043, 108th Cong., 1st Sess. (2003).

July 16, 2003.[113] Aside from further slowing the progress of the Basel II proposal, one effect of the bill would be to reduce the relative influence of the Federal Reserve in committee negotiations.[114] This development, and the continuing Congressional criticism of the Basel II process, prompted the Deputy Secretary General of the Basel Committee to criticize publicly the "politicized" process fostered by intense lobbying by U.S. banks.[115] Not surprisingly, this criticism elicited a harsh response by congressional leaders and U.S. bank lobbyists alike.[116] By mid-July 2003, the process became even more politicized, as lobbyists for the relatively smaller "community" banks urged Congress to include the Office of Thrift Supervision on the interagency committee, so that the Office—the U.S. regulator of relatively smaller savings associations and their holding companies—would have a formal role on the Basel Committee.[117]

Even the largest U.S. banks are not entirely comfortable with Basel II. In testimony before the House Financial Services Subcommittee on Financial Institutions, representatives of this group expressed opposition to a capital charge for operational risk under Pillar 1, preferring "improved bank supervision" under Pillar 2 as "the best way to tackle operational risk."[118] This view reinforces the

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113. Karen L. Werner, *House Subcommittee Approves Measure Establishing Federal Basel Policy Committee*, BNA BANKING DAILY, July 17, 2003.

114. R. Christian Bruce, *Hawke Supports Fed on Operational Risk*, *supra* note 118, at 2. The proposed interagency committee would include the U.S. Treasury Secretary as chair, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency (supervisor of national banks), and the Chairman of the Federal Deposit Insurance Corporation. *Id.*

115. *See* Patrick Tracey, *Basel Committee on Banking Supervision Questions 'Integrity' of Congressional Review*, BNA BANKING DAILY, June 26, 2003 (discussing controversy). Germany's central bank, the Bundesbank, also criticized U.S. efforts to re-open key elements of the agreement, arguing that these efforts threatened to terminate the Basel II process. Daniel Pruzin, *Basel Committee Expected to Focus*, *supra* note 118, at 2.

116. *See* Patrick Tracey, *Basel Committee*, *supra* note 15, at 1 (discussing controversy); *Shelby Counterattacks Basel Official Who Questioned Campaign Funds From Banks*, BNA BANKING DAILY, June 27, 2003 (reporting Senate Banking Committee Chair's characterization of remarks as "uninformed and highly inappropriate").

117. Karen Werner, *Bachus Urged to Amend Legislation, Place OTS on U.S. Basel Policy Committee*, BNA BANKING DAILY, July 15, 2003, at 1. At the same time, the lobbyist group, America's Community Bankers, repudiated suggestions that the U.S. Securities and Exchange Commission be given membership in the interagency committee. *Id.* at 2.

118. R. Christian Bruce, *Hawke Supports Fed on Operational Risk, Says Basel Method Offers Enough Discretion*, BNA BANKING DAILY, June 20, 2003, at 1. The Swiss Government and the Swiss banking community have also expressed concerns about the capital requirements for operational risk. Daniel Pruzin, *Basel Committee Expected to Focus On Future of Beleaguered Capital Accord*, BNA BANKING DAILY, Oct. 10, 2003, at 2. In contrast, despite similar complaints from relatively smaller banks and other financial services firms, the European Commission announced on July 1, 2003, that it would implement an adapted version of Basel II by 2006. Joe Kirwin, *EC Outlines Proposal to Implement New Basel Rules on Capital Adequacy*, BNA BANKING DAILY, July 2, 2003. However, continuing transatlantic disagreements over Basel II, and the Basel Committee's decision to propose added revisions, now appear likely to delay drafting of EU implementing legislation. Arthur Rogers, *Delay in the Basel II Process Forces EU To Postpone Draft Implementation Process*, BNA BANKING DAILY, Oct. 22, 2003. For discussion of the Basel Committee's decision, see Daniel Pruzin, *Basel Committee Pushes Back Target Date, Proposes Added Revisions to Capital Accord*, BNA BANKING DAILY, Oct. 15, 2003.

suggestion that the Basel II process is about rule-creation, not merely exhortation of "best practice." Likewise, the opposition of the British Bankers' Association and the London Investments Banking Association to Basel II is explicitly based on their preference for a more "principles-based" approach rather than what they perceive as "prescriptive rules" in the latest version of the proposal.[119]

IV. CONCLUSION

As a practical matter, there is no discernible distinction between the intensity of the criticism and negotiations surrounding the proposal and that which surrounds the negotiation of a major treaty undertaking or a significant legislative proposal. It is difficult to credit the insistence of the BIS that what is at the heart of the extended consultations over Basel II is merely a "statement[] of best practice." While it is true that the Basel Committee possesses no "formal supranational supervisory authority," that observation seems to belie the fact that the contemporary practice of the Committee seems to represent the emergence of a new kind of source of law: an international administrative practice involving rule proposal for public comment, revision in light of public comments, and adoption, implementation, and enforcement at the national level.

119. *Cf. supra* note 90 and accompanying text (discussing associations' opposition).

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