A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on a Public-Private Partnership

Professor Joseph J. Norton*

I. Introduction: Globalization and its Discontents

A perceived trend in the context of international economic activities is the shift towards forms of private governance or at least greater reliance by the public sector on private sector involvement. This article observes this trend in the area of international banking regulation and supervision. It is concerned with what the author perceives to be an evolving "public-private partnership" among governments, banking authorities, and large and complex banking organizations (LCBO), referred to below as "elite banks," with respect to fundamental dimensions of modern international financial regulation. Because of time and space constraints, this article will focus solely on this trend in the context of the international regulation and supervision of the modern genre of financial institution risks. However, the author's informed intuition suggests that this trend can be detected and analyzed in other

*J.D., D.Phil, LLD (h.c.). James L. Walsh Distinguished Faculty Fellow and Professor in Financial Institutions Law, SMU Dedman School of Law, Dallas, Texas and Sir John Lubbock Professor of Banking Law, CCLS, Queen Mary, University of London. The author would like to express his appreciation for the substantial input and comments provided by his colleagues, Dr. H. M. Shams, and Mr. C. D. Olive. This article is derived from a 1997 research study conducted by the author and Mr. Olive (see note 3 infra), and a recent 2002 paper presented with Dr. Shams (see note 10 infra) for an Oxford University Press Symposium on "Law and Privatization" (2002).


areas of international financial regulation including international capital markets, corporate governance, economical/financial criminality, and anti-terrorism issues.

The rise of LCBOs through consolidation and diversification into new activities and risks has been swift and defining over the past decade. This consolidation trend of LCBOs will most likely continue, as new legislation recently enacted by the United States and other major financial jurisdictions (e.g., Japan and Korea) paves the road to even more powerful and diverse financial institutions in the form of "financial holding companies." In this sense, these LCBOs and financial conglomerates (sometimes referred to as LCFIs, "large complex financial institutions") will be the major "actors" in international financial transactions and markets. In specific terms, as to these "actors," financial transactions and markets, this article explores the notion of a "risk-focused" supervisory regime coupled with a "self-regulatory" regime (i.e., "qualified self-regulation") as a modern manifestation of and a trend towards "a quasi or partial privatization" of what traditionally would have been the exclusive domain of government.

II. The Subject-Matter of Risk-Focused Bank Regulation/Supervision: The Backdrop

The evolution of bank activities and the development of bank regulatory and supervisory frameworks on domestic, regional, or international bases have been underscored by frequently occurring periods of distress and crises throughout recent history. The recent Asian, Russian, Turkish, Argentine, and Brazilian financial crises and their globally contagious impact are but several contemporary examples. Even developed countries and re-

8. LCBOs are, in effect, a type of "financial conglomerate" with the bank as the center-piece. The LCFIs would be financial conglomerates that might be dominated by another type of financial institution, such as a specialties firm or insurance company.
gions have not been immune. In particular, banking authorities in the United States and Japan have encountered systemic periods of distress and crisis while attempting to maintain the "safety and soundness" of their respective banking and financial systems and specific banking institutions. The U.S. thrift and banking crisis of the 1980s and early 1990s, as well as temporary crises generated during the financial market turbulence of 1998, graphically illustrate this point.13

Yet, within and through these recurring periods of crisis, banking activities have continued, over the past several decades, to evolve from traditional deposit-taking and lending activities into a diverse range of non-traditional counterparty activities that transverse the entire sphere of financial products and services. The "traditional" bank lending and depository activities are becoming less significant, relegated more or less to "relationship banking," as global competition leaves banking institutions with diminishing opportunities to profit from traditional business lines.14 In particular, the U.S. banking industry and especially LCBOs have experienced extraordinary growth and diversity over the past two decades into new activities through rapid advancements in information technology, telecommunications, and financial innovation, as well as through deregulatory initiatives from the respective U.S. banking authorities.15

The U.S. banking industry's expansion into new and increasingly complex activities has significantly increased competition both within the banking industry (LCBOs in particular) and between the banking industry and other financial service industries, particularly securities and insurance.16 This enhanced competition, in turn, has facilitated systemic consolidation within the banking and financial services industries.17 The result of this consolidation is the relatively recent formation of a distinct class of LCBOs undertaking complex risks in conducting sophisticated financial activities, services, and products across increasingly volatile financial markets.18 The expansion of LCBOs into non-traditional and diverse activities and cross-border structures has established even more diverse and complex risks and linkages within and among banking systems and financial markets in developed and developing nations alike.19

These risks and linkages have expanded also the nature and scope of banking-customer relationships particularly over the past decade. LCBO underwriting, dealing, issuing, and

proprietary trading activities in capital markets, structured finance markets, and over-the-counter (OTC) derivatives markets has become the new "engine" of the modern global banking business. Thus, advances in technology and financial innovation, as well as deregulatory initiatives of the U.S. banking authorities, which eventually set the stage for the enactment of dramatic financial modernization legislation in 1999, have consistently expanded the range of activities and risks conducted by large banks and LCBOs. These activities and risks, particularly activities involving, and risks arising in connection with, OTC derivatives and structured financial products, have increasingly refined LCBO and supervisory methodologies for measuring and managing risk.

The evolution of LCBOs as a cognizable class has occurred often through opaque maneuvering by the Basel Committee on Banking Supervision (the "Basel Committee"), the key Central Bank Supervisors [e.g., the U.S. Board of Governors of the Federal Reserve System (FRB), and the U.S. Comptroller of the Currency (OCC, a bureau of the U.S. Treasury Department)] in support of continued global banking industry consolidation. In the global bank supervisory context, the evolution of LCBOs has been explicitly addressed and implicitly supported through consistent efforts of the Basel Committee on several fronts. First, the Basel Committee has recognized certain LCBOs as “financial conglomerates,” and has worked jointly since 1995 with the International Organization of Securities Commissions (IOSCO) and other authorities through the “Joint Forum” platform to develop regulatory and supervisory guidance on handling these institutions. Second, the Basel Committee has increasingly issued guidance that focuses on global bank risk management and internal control systems, as well as public and regulatory disclosure of complex activities and risks arising from such activities. Third, the Basel Committee has increasingly vested discretion in LCBOs to identify and to measure risk, subject to generally objective criteria using “internal models,” such as through the Market Risk Amendment to the Capital Accord and in the more recently proposed modifications to the credit risk-based provisions of the Capital Accord. Fourth, the Basel Committee has recently proposed major revisions to the Capital Accord in an attempt to refocus emphasis with respect to global banks.

In effect, the Basel Committee and key national bank regulators attempt to meet the challenges presented by the global banking consolidation trend and new complex activities and risks by developing and implementing distinct “risk-based supervision” frameworks. By this, they redirect examination techniques to emphasize risk management and internal control systems, as opposed to determining through transaction testing and other static means whether a bank or LCBO is operating in a safe and sound manner at a given time.

This evolution to risk-focused supervision is a direct response to dramatic changes in the banking industry and the rapidly declining time in which risk profiles can change significantly. The risk-focused supervision approach is intended to be more "forward looking" than the "transaction testing" approach, and to focus on bank risk management practices and internal control systems to manage current and prospective risks. The risk-focused approach facilitates the development of supervisory plans that are tailored for each individual bank or LCBO risk profile and organizational structure.

III. The "Public-Private Partnership" Notion

A. In General

The expansion and diversification of large banks and LCBOs into complex activities and cross-border structures through consolidation has generally separated certain global banks and LCBOs into a fairly small class of global banking organizations (i.e., "elite banks" referred to above). The majority of global bank resources are undoubtedly concentrated in certain of the elite banks. The elite banks are engaged in intense global competition in all activities, have complex cross-border organizational structures, and undertake increasingly greater and more complex risks to enhance revenues and profits. The elite banks are the primary vehicles for the transmission of government monetary, credit, and exchange rate policies, and hold significant assets and counterparty linkages throughout global banking and financial markets.

Therefore, home and host nation authorities are either directly or indirectly subjected to a "public-private partnership" to some extent with the elite banking industry. The elite banks are the institutional fabric that connects domestic and international banking and financial markets through their credit, intermediary, and proprietary functions. As such, the vestiges of this public-private partnership define the parameters of elite bank regulation and supervision. This "partnership" may not necessarily exist between governments and other financial institutions, although this point is certainly debatable with several of the largest and most complex securities and insurance conglomerates at this time.

1. The "Special Relationship"

The distinguishing implementation of elite bank regulation and supervision in the form of a public-private partnership is premised in part on the uniquely complex risk profiles, and global capital and organizational structures, of elite banks as compared to other non-bank financial institutions. For example, elite banks maintain a complex funding profile that consists, to a significant extent, of customer and interbank deposits withdrawable on demand, short-term debt relationships derived from capital markets, and significant counterparty linkages developed through securitization and OTC derivatives markets.


Further, elite banks generally maintain substantial degrees of leverage relative to capital. In addition, bank loan and other credit assets, which represent a significant percentage of total assets, are generally more illiquid than securities and other financial instruments held by securities firms or other financial institutions.26

The elite banks are also generally either implicitly or explicitly, supported by some form of explicit or implicit government “guaranty” to prevent or mitigate the systemic effects of bank insolvency, such as a deposit insurance scheme or other guaranty of deposit/lending obligations. Deposit insurance or government guarantees to elite banks exist in order to contain the real (or perceived) threat of contagion and potentially enormous macroeconomic costs of liquidity problems in times of market stress.27 The uncertainty and inconsistency over primary and secondary market credit valuations of elite banks and their respective assets, liabilities and hedging transactions, however, necessarily leads to more difficulty and less transparency in determining the financial condition of an elite bank at any given time.28 Nonetheless, the range of elite bank activities involving other non-traditional, complex financial services and products clearly extends the scope of explicit or implicit safety nets.29

The elite banks should, therefore, be viewed as “special” institutions; and these factors, along with the credit, intermediary, and proprietary functions necessitate that governments and elite banks are bound by certain flexible constraints inherent to the partnership.

The parameters of their partnership are worth exploring; and, although the theoretical and practical examination of these parameters is currently in its infancy, several observations may be noted. First, the partnership is both formal (established through banking laws, regulations, and other supervisory guidance) and informal (established through certain supervisory and market practices and understandings not necessarily reduced to writing). Second, there are various responsibilities of the partnership to be fulfilled by governments and/or banking authorities. Third, there are various responsibilities to be fulfilled by the elite banking institutions in this configuration.

2. The Governments and/or Banking Authorities

Banking authorities have the incentive to avoid undertaking regulatory or supervisory actions that unnecessarily hinder opportunities for their constituent elite banks to remain competitive and profitable on a domestic or international basis. Instead, the banking authorities maintain the incentive to support and to enhance elite bank opportunities to diversify into new activities and otherwise to earn greater profits so long as the risks arising from such activities are not per se disproportionately excessive or beyond the scope of supervisory oversight. For example, the U.S. banking authorities have engaged, consistently and actively, in deregulation to ensure that large banks and LCBOs remain able to increasingly engage in nonbank activities. The U.S. banking authorities also strive to achieve a balance in regulating and supervising foreign banking organizations operating in the United

---


States to promote "level playing fields" and to ensure that U.S. banking organizations receive equal access to foreign markets. These U.S. regulatory incentives are supplemented by prudential "safety and soundness" considerations through appropriate administration of risk-based to capital requirements.

Banking authorities arguably maintain certain interesting incentives as part of this partnership. For instance, banking authorities have the incentive to ensure that monetary policy objectives do not unnecessarily create undue conflicts between their constituent LCBO industry and bank regulatory and supervisory objectives. The banking authorities would necessarily desire to avoid implementing policy objectives that would submit the banking system to unnecessary macroeconomic volatility, asset-liability or foreign exchange mismatches, or inflationary expectations that would fuel asset price bubbles and speculative lending or derivatives such that the policy objectives disadvantage or threaten the banking system.  

Banking authorities also generally lack the expertise or resources available to elite banks and, therefore, have the incentive to seek out the counsel and advice of constituent elite banks on issues pertaining to monetary, supervisory, and regulatory policies prior to or during their implementation. Banking authorities further have the incentive to alert and to protect their constituent elite banks from risks or conditions that may not be entirely within their ability to control, such as political risk of untimely or inappropriate government action. Banking authorities also have the incentive to create, promote, and enhance "market discipline" mechanisms for elite banks to engage in "self" and "collective" regulation and supervision of risks that are generally within their ability to control.

Finally, banking authorities have the incentive to punish or to eliminate the demonstrably reckless partners of the partnership or to facilitate their consolidation into other stronger banking institutions so that the partnership may continue to evolve. Effectively, banking authorities have every incentive to address the most problematic or systemic issues that arise with their constituent banking organizations largely out of the public domain where they can be handled "appropriately" with as much discretion as possible and without the onset of destabilizing or politically motivated intervention.  

3. The Elite Banks

The elite banks have the incentive to work with the banking authorities, directly or indirectly, to ensure that monetary, supervisory, and regulatory policies are effectively balanced, developed, and implemented. The elite banks also have the incentive, implicitly or explicitly, to engage in political action or inaction to protect and to support their respective banking authorities when they come under political scrutiny for risks undertaken by the banks. The elite banks allow banking authorities to view the "secrets of the temple," including sensitive proprietary information such as risk management and internal control systems, in order to protect against risks within their control and anticipate risks beyond their control. Finally, and perhaps most importantly, the elite banks have the incentive to assist banking authorities in preserving the safety and soundness of the domestic and international banking system through non-transparent but quasi-orderly workouts of large

---

30. A most difficult concept to address is how developing nations should adjust their macroeconomic and exchange rate policies to address volatile private capital flows. See, e.g., Hearing on Proposals for a New International Financial Architecture, Committee on Banking and Financial Services, U.S. House of Representatives (May 20, 1999) (testimony from various experts).
distressed borrowers and other counterparties (such as OTC derivatives counterparties). The elite banks and their respective banking authorities, in turn, work with governments and international financial institutions (IFIs) to ensure ultimately that large borrowers or counterparties in distress are dealt with "appropriately."

4. A Symbiotic Framework?

The "public-private partnership" evidences particular understandings between elite banks and their banking authorities that represent a form of a symbiotic framework of "safe passage" among and between them. The partnership parameters are defined through the bank regulatory and supervisory frameworks as well as the implicit balances of power that necessarily exist between elite banks and banking authorities. As the elite banks represent crucial policy vehicles to their respective governments, the government authorities conducting monetary policy and the banking authorities conducting bank regulation and supervision (to the extent that such agencies are separate) have every incentive to ensure that their constituent elite banks remain sound, competitive, and robust. The elite banks presumably prefer to have discrete self-regulatory frameworks, but may also desire supervisory oversight relationships as additional checks and balances against complex risks overtaking their risk management and internal control systems.

The elite banks are already subject to an extensive global regulatory and supervisory framework. The current global bank regulatory and supervisory framework is nonetheless arguably tilted in favor of elite banking interests versus the interests other bank classes. In other words, banking authorities naturally seek to implement and to enforce regulatory and supervisory policies so as to enable the elite banks to:

• engage in bank and nonbank activities that present maximum opportunities for profit;
• diversify within and among different lines of business to maintain competitiveness;
• remain relatively free of unnecessary government restraints, burdens and costs that work against these objectives;
• maintain access to necessary funding and certain protections in times of crisis (such as government liquidity or intervention guarantees or deposit insurance); and
• simultaneously develop, implement, and enforce effective risk management and internal control systems and preserve capital to cushion losses from those activities.

The larger and more influential elite banks, the interests of which are more readily acknowledged and addressed by the political and regulatory processes (but nonetheless are aligned in most respects to the partnership) presumably enjoy a stronger and more mutually beneficial relationship with their respective banking authorities. The banking authorities are often faced with external market shocks and monetary, supervisory, and regulatory policy decisions where a given policy decision would likely affect different banks and economic sectors or regions differently, or otherwise might diminish the profit opportunities of the elite bank class as a whole. If conflicting policy decisions become self-evident, then banking authorities presumably would tend to adopt policies that favor the interests of the larger and more influential elite banks, perhaps to the detriment of the smaller and less influential banks, economic sectors, and safety and soundness concerns. The larger and more influential elite banks have global interests spread across the international financial markets. The safety and soundness of elite banks is enormously important to the banking authorities; once again, perhaps to the detriment of other banking institutions and economic interests. The reality is that more influential elite banks, in all likelihood, exert greater influence upon
banking authorities than the authorities exert upon them. Accordingly, to the extent that elite banks and banking authorities diverge on issues affecting the partnership, the elite banks would presumably exert far greater influence on the banking authorities to set agendas and priorities as such.

These basic deductions are supplemented by the realization that the larger and more influential elite banks have considerably greater financial and intellectual resources at their disposal than the government agencies in terms of expertise in dealing with increasingly complex and global risk exposures. The subtle conclusion here is that, notwithstanding regulatory influence upon elite bank risk management infra-structures and upon associated risk-focused supervision, banking authorities arguably may have little choice in the medium-to long-run but to defer to "market discipline" to have a greater impact on elite bank "business judgment" in such matters than risk-focused supervision (or to form a primary element of risk-focused supervision). The reliance on "market discipline" as an element of risk-focused supervision for elite banks may render bank regulatory frameworks as mere parameters for the partnership to address problems after they arise, as supplemented by close supervisory oversight of and implication of public disclosure requirements on elite banks to ensure that potentially significant problems are anticipated and pre-empted by market forces before they arise. The concepts of close supervisory oversight, enhanced regulatory enforcement of risk management and internal control systems, and, most importantly, the use of "market discipline" through elite bank public disclosures of certain risks or structural characteristics, should be used to rebalance the partnership parameters.

IV. Public-Private Partnership Dynamics

The parameters of this public-private partnership become especially dynamic, such as in the United States, where different classes of banking interests exist and similar banking and financial conglomerates are subjected to different strains of regulatory and supervisory oversight by different and/or multiple government financial authorities. In recent history, the U.S. financial authorities lacked uniformity in how they work with, supervise, or regulate their respective financial organizations, both within and beyond the United States. Thus, "supervisory and regulatory arbitrage" opportunities existed in legion on domestic and international bases.

The elite banks have had every incentive to (and generally do) exploit such arbitrage opportunities through financial and legal innovations. In fact, the financial authorities often encouraged such behavior with respect to authorizing their respective institutions to diversify into new activities, and to devise new financial structures at different times and in different ways. The regulatory and supervisory arbitrage opportunities place the financial authorities in the situation where they have had to compete with each other, from a "regulatory jurisdiction" perspective, in order to preserve the rationale for their existence.

31. See generally DeFerrari & Palmer, supra note 21, which discusses all key, related FRB supervision and regulation (SR) letters from 1999 through 2000.

SPRING 2003
As partnership parameters, such as described above, become more dynamic, however, special interests involved in the banking and financial service industries become increasingly vested in the legislative and regulatory processes. The elite banking interests become more entrenched, and fight to prevent losses of market share or explicit or implicit regulatory subsidies that previously sustained them. The elite banks continuously search the world over for business opportunities abroad that they might be limited or prohibited from conducting within their home nations, and they press their interests forward with foreign governments to establish and protect their opportunities and interests. This is particularly evident as one realizes the enormous opportunities for regulatory arbitrage and regulatory jurisdictional ambiguities existing at the international level, particularly between and among developing nations with far less transparent and less meaningful regulatory and supervisory frameworks. The consistent exploitation of regulatory arbitrage opportunities by elite banks effectively forces developing nations to take measures to protect their domestic banking and financial service industries from foreign influence and control, which cuts against any incentives for establishing meaningful international “free trade” in banking and financial services.

The modern public-private partnership also consistently provides elite banks with incentives consistently to “push the envelope” of complex risk-taking in their activities. The development and implementation of legitimate risk management and internal control systems becomes most critical as elite banks and national banking and financial systems consistently encounter periods of systemic risk, distress, crisis, and failure. Banking and financial system crises generally have multiple and diverse causes and any given crisis generally cannot be explained by a single cause. The causes of any such crises usually arise from basic ambiguities, gaps, omissions, or outright failures to perform under the public-private partnership by elite banks or banking authorities. The basic ambiguities, gaps, or failures to perform under the partnership generally results in “boom-bust” periods underscored by elite bank credit, market, operational, or other risk exposures in excess of what they can or will adequately manage and, therefore, tend to cause the banking authorities to react or to intervene only on an “after the fact” basis.

The banking authorities’ reaction to “boom-bust” periods and to excessive risk-taking may be to intervene directly or indirectly in an untimely and/or inappropriate manner through monetary, supervisory, or regulatory policy. The intervention methods themselves may incorporate “lessons learned” from risk management and internal control failures in the short run, but likely will reinforce “moral hazard” incentives in the longer run to inadvertently encourage elite banks to continue to engage in excessive risk-taking without meaningful risk management and enforcement of internal control.

The basic decision of a banking authority to intervene comes down to another “business judgment”; should the authority intervene directly or indirectly and meaningfully address the situation, or otherwise should it engage in forbearance and trust that the elite bank or banks will address the perceived inequities? The nature and extent of the business judgment is related necessarily to the following conceptual questions. First, how and on the basis of

---


what information should elite bank risk management and internal control systems be continuously supervised and evaluated by banking authorities over time? Second, how can the credit, market, and operational risks undertaken by an elite bank be measured and its capital adequacy evaluated in real time? Third, how can elite bank senior management be held accountable for meaningful deficiencies in risk management and internal control systems and for capital inadequacy? Fourth, how should such accountability be defined and determined (in terms of regulatory enforcement or public disclosure or both), and what is the objective of holding persons or institutions accountable? Fifth, what should be the standard for holding such senior management accountable for risk management and internal control failures that result in substantial losses to the banks and/or jeopardize the national or global banking and financial systems? These questions should be cautiously explored in developing future reforms to large bank supervision and capital adequacy frameworks.

The path of least resistance for banking authorities faced with such challenges and business judgments will be to take no direct enforcement actions against elite banks for such failures in this regard, but to pursue forbearance policies in the name of "market discipline." The concept of "market discipline" as an emerging regulatory paradigm provides that the market participants will allocate accountability for excessive elite bank risk-taking that actually or potentially results in substantial risk management and internal control failures and losses under an increasingly "self-regulatory" regime. The pursuit of forbearance policies by banking authorities, however, may lead to political intervention, loss of banking authority credibility, and increased costs for resolution of ensuing bailouts.

However, effective market discipline will occur only if meaningful information regarding elite bank risk management and internal control failures are disclosed to the public and/or other government authorities. If significant elite bank risk management or internal control failures occur, then the issues of accountability and compensation in terms of who will be held accountable for the condition of the organization, and who will or will not be compensated in times of crisis become even more significant? The resolution of these issues generally should be developed by consensus between the elite banks and banking authorities under the public-private partnership framework. But, if the balance of power in the public-private partnership generally lies with the elite banks, then banking and financial interests will generally govern the solution, and that solution will generally facilitate non-transparent relations between elite banks and banking authorities.

V. Elite Bank Risk-Focused Supervision and Qualified Self-Regulation

The U.S. banking authorities' and the Basel Committee's approach as to elite banks has generally resulted in the development of a regulatory and supervisory framework for elite banks comprised of risk-focused supervisory oversight coupled with qualified "self-regulation." There is little question that elite banks generally possess far greater expertise and resources to identify, measure, monitor, and manage complex risk exposures, using sophisticated risk measurement and aggregation methodologies, than is available to most (if not all) domestic banking authorities. The "risk-focused supervision" concept essentially redirects responsibility and accountability for the design, development and implementation of risk management and internal control systems to the elite banks themselves, subject to general and objective (and, at times, subjective) standards for such systems established by the banking authorities, and to supervisory oversight of such systems.

This approach admittedly leaves significant discretion to the elite banking community (in terms of development and implementation of such systems, and the provision of timely
and meaningful information generated by such systems disclosures to the banking authorities) and the banking authorities (in terms of relative degree of supervisory oversight and enforcement of those systems and access or diligence in obtaining such information). The nonbank activities of elite banks, carried on through financial holding companies, bank holding companies, bank subsidiaries, and nonbank affiliates, may be subject to both supervisory oversight by the banking authorities and functional regulation by other respective financial authorities, depending on the jurisdiction (particularly in the United States). The elite banks operationally are increasingly managing their activities and systems along business lines on a more centralized basis, as opposed to distinguishing approaches based on legal entities.

The risk-focused supervision framework essentially provides elite banks with substantial discretion to develop, implement, and enforce risk management and internal control systems, subject to the development and application of objective and subjective supervisory standards and narrowly focused supervisory oversight on material risks arising from elite bank activities. The risk-focused supervision framework is also being used to refine appropriate risk-based capital requirements for elite banks. Finally, the banking authorities maintain substantial discretion on how to conduct supervisory oversight of large banks and LCBOs under this guidance.

The movement towards risk-focused supervision and qualified “self-regulation” became primarily evident through the Basel Committee’s introduction of the Market Risk Amendment to the Capital Accord in January 1996, as implemented by the U.S. banking authorities and other authorities at the domestic level. There is little question that elite banks were the “primary drivers” behind the Basel Committee’s adoption of the Market Risk Amendment in its current form and its most significant aspect, the “internal models” approach for determining market risk capital requirements as a basis for capital adequacy regulation for elite banks with significant trading activities. The “internal models” approach authorizes certain qualifying elite banks to develop and to utilize their own risk management (particularly, risk measurement) systems to measure capital requirements using models tailored from the collection of “value-at-risk” (VaR) methodologies, subject only to certain quantitative and qualitative parameters established by the Basel Committee. The “internal models” approach essentially provides elite banks with significant discretion to determine their own market risk capital requirements using individually tailored VaR methodologies.

The Market Risk Amendment represented a paradigm shift in global bank supervision, but the activities covered are a fairly small part of global risks assumed by the elite banks. The far more significant impact of the Market Risk Amendment was the clear signal that such an “internal models” approach could eventually be introduced for credit risk, in the form of revised credit risk-based capital requirements under a new Basel Capital Accord. The Basel Committee moved decisively closer to this state of affairs by proposing an entirely new capital adequacy framework to replace the currently existing Basel Capital Accord in June 1999, and then re-proposing this new framework in January 2000, updating it in June 2000, revising it in December 2001, and elaborating further on it in July 2002 (Basel II).

---

36. See Basel Committee on Banking Supervision, Amendment to the Capital Accord to Incorporate Market Risks (1996).
38. See Basel Committee on Banking Supervision, A New Capital Adequacy Framework (June 1999), as re-proposed and revised. See Basel Committee on Banking Supervision, The New Basel Capital Accord (July 2002).
The new Basel II capital adequacy framework proposes a three-pillar approach towards addressing credit risk: (i) "minimum capital requirements," (ii) "supervisory review of capital adequacy," and (iii) "market discipline." A review of the restated framework and subsequent statements by leading bank authorities indicates a clear intent to shift responsibility for the design and implementation of credit risk capital requirements more to the banks themselves under such an "internal models" approach.\(^9\)

The clear trend towards risk-focused supervision and qualified "self-regulation" is also demonstrated by banking authorities' reluctance to regulate OTC derivatives markets directly. The U.S. and other banking authorities have conducted various studies of the OTC derivatives market since 1993, and have weathered periods of significant market stress dominated by events involving OTC derivative activities. These events, including recent Russian financial crises in 1998 and the financial LTCM debacle, arguably demonstrated that enhanced prudential standards and supervisory oversight of these activities may be desirable.\(^4\) Nonetheless, elite banks and their respective banking authorities jointly engaged in considerable efforts over the past several years to pre-empt any momentum towards adopting any distinct "regulatory framework" for OTC derivative activities, and even meaningful public disclosures of these activities.\(^4\) Notwithstanding progress made in disclosure of such activities to banking authorities themselves as evidenced by Basel Committee annual surveys of elite bank OTC derivative activities conducted over the past several years. These positions have been established and maintained notwithstanding available information that suggests that OTC derivatives, and the handful of global elite banks acting as primary dealers and counterparties in these instruments, collectively assert a dominant yet volatile influence over spot and exchange-traded interest rate, foreign exchange and even commodity markets, and facilitate excessive leverage and illiquidity in such markets, which (in turn) facilitate or exacerbate periods of market stress.\(^4\) These trends are readily

---


SPRING 2003
acknowledged in several important reports issued by the U.S. President’s Working Group on Financial Markets, consisting of the U.S. banking authorities, Treasury Department, SEC, and CFTC, but nonetheless significantly influenced by the banking authorities, and in various post-1998 Basel Committee papers.43

The risk-based capital amendments and proposals for the Basel Capital Accord and regulatory postures adopted for OTC derivatives markets are facilitated by a recent plethora of “best practices” guidance for risk management and internal control systems. This guidance was developed and issued primarily through the Basel Committee in close consultation with the elite banking industry and other international regulatory forums (e.g., IOSCO, Joint Forum, and Financial Stability Forum).44 The industry groups consulted in this regard included the Counterparty Risk Management Policy Group, International Swaps and Derivatives Association (ISDA), the Group of Thirty, and the Institute of International Finance (IIF).45 These reports focus primarily on the development and implementation of “best practices” with respect to identifying, measuring, monitoring and managing credit risk, market risk, operational risk and liquidity risk management, and managing relationships with and risk exposures to highly leveraged institutions such as hedge funds.

The driving force behind the guidance issued to address these complex areas is the dangerously consistent occurrence of episodes of market stress, suggesting (if not demonstrating) that elite banks may not consistently implement and enforce risk management and internal control systems. A careful review of these public-private efforts to develop guidance, and the market stress events and risk management and internal control failures on which they are premised, also suggests that the recommended “best practices” are well-articulated and user-friendly principles addressing complex matters (but not inherently complex in themselves nor are they entirely new ideas to the elite banking community). The guidance instead represents a series of ambitious restatements of fairly elementary risk management and internal control principles already inherent in law, regulation, accounting and common sense that elite banks, with their expertise and resources, already have integrated into their global banking and trading operations.


Nonetheless, elite banks and their banking authorities have repeatedly been caught in significant risk management and internal control failures in recent times. The specific institutional and regulatory failures include, among others, the well-known Barings Bank plc, Daiwa Bank (New York) and Sumitomo Bank “rogue trader” episodes of 1995–1996, the NatWest derivatives pricing/internal control debacle and similar failures in 1997, and the money laundering scandals involving the Bank of New York and other major U.S. and European global banks of August 1999–present. The more significant “industry” failures certainly include the OTC derivatives and counterparty credit episodes underscoring the Asian and Russian financial crises over 1997–1998, and most importantly the LTCM episode of 1998, and the current Argentine and Brazilian financial crises respectively.

These above referenced examples cumulatively suggest that the risk management and internal control standards established through Basel Committee and U.S. banking authority guidance may not, from time to time, be successfully implemented or meaningfully self-enforced by the elite banks. The intellectual frameworks for risk management and internal control systems have undoubtedly been organized and articulated to the elite banking industry through the Basel Committee and U.S. regulatory channels. The collective motivation and incentives for elite banks to successfully implement and meaningfully enforce these standards appear to be absent or compromised by profitability concerns. An important question in this regard is whether the appropriate ingredients for “market discipline” are lacking because of complexities underlying the implementation and enforcement of these systems in complex global financial markets, or because of voluntary, knowing, or subliminal decisions rendered at the middle or highest levels of elite bank senior management to avoid full enforcement of systems given perceived effects of such enforcement on elite bank profits.

The Basel Committee (and U.S. banking authorities) may have presupposed too much at the outset by assuming that “market discipline” incentives implicitly would guide the elite banks to implement and meaningfully to enforce their own comprehensive risk management and internal control systems. The recent financial market events, particularly with respect to the LTCM episode and FRB-induced private-sector bailout, exhibited clear elite bank breakdowns or outright failures to enforce risk management and internal control systems at the highest levels of these institutions. The relative absence of banking authority enforcement actions or consent orders against elite banks addressing such failures as “unsafe and unsound” banking practices in the U.S. or addressing the periodically excessive risk exposure incurred by elite banks in OTC derivative activities, arguably demonstrates that U.S. banking authorities may be unable or unwilling to hold elite banks directly and fully accountable for their actions or omissions in this regard. How all this “sounds” for the


47. See, e.g., Basel Committee on Banking Supervision, Supervisory Lessons to be drawn from the Asian Crisis (1999); Basel Committee on Banking Supervision, Sound Practices for Banks’ Interactions with Highly Leveraged Institutions (1999).
viability of the newly evolving public-private partnership in banking supervision remains, at minimum, highly problematic.

VI. Concluding Observations

The genesis of systemic capital impairment is traceable to basic conflicts in the role of government intervention in banking systems and international financial markets. The role of government in this sense is necessarily defined by the parameters of the public-private partnership, however. The imposition of more stringent and detailed risk-based bank capital requirements, without more, cannot unilaterally resolve this issue without changes in the public-private partnership dynamics regarding supervisory oversight and enforcement of risk management and internal control systems. The major issues relating to bank capital adequacy now focus on the changing nature and transparency of risk measurement techniques, including valuation and revaluation of complex OTC derivatives, and other financial instruments and structured transactions, and portfolios thereof, in the context of domestic and international, legal and economic events. The application of the aforementioned objectives to address elite bank capital impairment should be conducted with a clear understanding of the various significant interests, relationships and linkages which establish the boundaries and pressure points of the public-private partnership. The framework for risk management and internal control systems needs to establish a careful and transparent rebalancing of power such that elite banking interests do not unduly influence or overcome the “safety and soundness” interests of banking authorities.

In general, a breakdown in the public-private partnership will usually precede the manifestation of elite bank or banking system crises such that it becomes difficult or impossible to isolate the independent effects of an ensuing crisis. The success of rebalancing the public-private partnership may well be inherent in the continued evaluation application and analysis of the risk-focused supervision and examination schemes for elite banks by the banking authorities. The effectiveness of elite bank risk-focused supervision and examination techniques will depend on many things, but primarily on the ability of examiners to identify and measure the risks presented by a given large bank or LCBO. The success of this approach will also depend on bank examiner expertise, independence, and access to proprietary information and to senior management and internal audit functions and understanding of present or emerging risks to the banking industry in its entirety through the examination process.

The most important challenges in this regard, however, include the following. First, ensuring that elite banks actually implement their risk management and internal control systems and use them as they are intended, and that examiners are actually able to identify and measure complex anomalies generated by these systems or otherwise or significant changes in elite bank risk profiles in a timely manner. Second, ensuring that the supervisory issues noted from bank risk management and internal control systems and/or during examinations or ongoing monitoring are actually raised directly to the appropriate bank senior management and addressed or resolved in a timely manner. The bottom line is that if examiners do not correctly identify and measure critical risks in particular business lines, they may go unaddressed until events overtake the respective institutions.

The LTCM debacle presents an excellent example of this because, quite clearly, bank examiners were not aware of the material risks incurred by elite banks in their lending and OTC derivatives counterparty activities with the hedge fund could cause to respective large banks and LCBOs through OTC derivatives counterparty activities and other credit-related
activities with the hedge fund. The large banks and LCBOs involved in this episode clearly did not implement or enforce their own credit risk or market risk management and internal control systems with respect to LTCM (and presumably other hedge funds and highly leveraged clients). Additionally, bank examinations are generally not designed to reveal operational risks such as insider fraud. Finally, bank examiners are enormously challenged by the complexity and diversity of bank risk management systems that utilize differing "internal models" to measure and account for risk on a real-time basis.

Large banks and LCBOs each undoubtedly design and apply "internal models" to measure market risk and credit risk that reflect their individual risk profiles. As such "internal models" are designed to be applied to specific risk profiles; elite bank internal risk models will likely differ even if intended to cover similar risk profiles. This ultimate "model subjectivity" renders it quite difficult for bank examiners, who are trained to rely on more objective bank models and measurements, to assess similar risks in a consistent manner. Of course, the accuracy of the output of these "internal models" depends on the nature of the input data used, and much of this input data is derived from internal and proprietary valuations of financial instruments such as OTC derivatives. There is little question that the "internal models" approach to risk-focused supervision of elite banks is in its infancy, and the banking authorities will need to take every step to ensure that their supervisory process does not get marginalized.

To summarize, banking authorities in developed nations in seeking to create the desired conditions for stability, predictability, and safety and soundness in their increasingly global financial markets have tended towards "risk-focused supervision" coupled with a qualified form of "self-regulation" vis-à-vis the major international banking institutions. This undoubtedly ties the potential for success to a proactive, constructive and transparent "public-private partnership." However, the ultimate question remains whether the international regulator/supervisors and international banks are up to the task of their new-founded "partnership" and whether the creation of an elite group of international banking institutions will prove a wholesome event in the evolvement of a "global financial system."

The duties of these new functions are expanding continuously, and this leaves open, serious fundamental questions of due process and compatibility with the core functions of financial institutions.

---

48. The reliance on financial institutions as agents of governance did not remain confined to the area of self-regulating their own "safety and soundness." Instead, for example, through a set of anti-money laundering regulatory requirements, financial institutions, in a very broad sense, are increasingly required to police the illegal activities of other private actors acting individually or in organized criminal groups. As most recently emphasized by the U.S. Treasury Department's General Counsel, financial institutions and their related professionals "have become the ears and eyes of the government... and, whether [they] like or not, [they] all have been deputized... It is a default mechanism because we [i.e., governmental authorities] do not have perfect intelligence, so we have to do something else, and that something else is watchfulness." See reported remarks of U.S. Treasury Department General Counsel David Aufhauser made on October 23, 2002 concerning the USA PATRIOT Act in 79 BNA Banking Rep. No 16, at 682–683 (2002). For further discussion, see Joseph J. Norton & Heba Shams, Money Laundering Law and Terrorist Financing: Post-September 11 Responses—Let Us Step Back and Take a Deep Breath? 35 INT'L LAW. 103 (2002); and Norton & Shams, supra note 10.