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PETER C. HAYWARD*

Prospects for International Cooperation by Bank Supervisors

Although banks have been operating internationally for many hundreds of years, cooperation among supervisors is a recent phenomenon and has been on a relatively restricted basis. However, international cooperation in the area of bank supervision moved into a higher gear with the agreement in July 1988 by the supervisory authorities in the "Group of Ten" countries on an agreed framework by which henceforward national authorities would measure the adequacy of the capital of the international banks for which they were responsible and, perhaps more significant, establish a set of minimum standards that all such banks would be expected to achieve by the end of 1992.[1]

This article assesses the significance of that achievement, for the Basle Committee on Banking Supervision where the agreement was reached, for the supervisory authorities represented there, for supervisory authorities in other countries, and for the banks themselves. It then describes the present and likely future scope for international cooperation, including the relationship of the Basle Committee with other international organizations and groups.[2]

I. The 1988 Agreement

The 1988 agreement is a modest, unpretentious document and, perhaps to the lawyer, rather unprepossessing.[3] The language is deliberately lay and avoids the

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The views expressed herein are the personal views of the author and do not necessarily reflect the views of the Supervisors Committee or of any of its members.

1. *See* BASLE SUPERVISORS COMMITTEE, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (July 1988).

2. For background information, see Norton, *The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on "International Convergence of Capital Measurement and Capital Standards,"* 23 INT'L LAW. 245 (1989).

3. *See generally* Cooke, *International Convergence of Capital Adequacy Measurement and Standards*, in FESTSCHRIFT FOR JACK REVELL (Institute for European Finance, 1990).

precision of a legal text. It is not even called an agreement but rather a "framework," a "statement," a "report," and a set of "recommendations." And it contains not a single "whereas" clause. It is not even signed; it merely has a footnote describing in general terms the sorts of institutions represented in the Committee. The document claims to have been "endorsed" by the Group of Ten central-bank Governors, but the inquiring investigator will find no statement uttered by the Governors to verify this claim.

Indeed, on the face of it, the document is nothing more than a statement of intent, a consensus that the authorities represented in the Committee "intend to implement in their respective countries at the earliest opportunity." Moreover, the document continues, "each country will decide the way in which the supervisory authorities will introduce and apply these recommendations in the light of their different legal structures and existing supervisory arrangements." The paper goes on to note that there are indeed great differences in these arrangements and the relative speed with which they can be changed.

There are a number of reasons for this informal approach. For a start, neither the members of the Committee nor the institutions they represent have the power to bind themselves formally in a treaty or any other form of legally binding agreement, let alone to legislate for the supervisory authorities in the many other countries which, as we shall see, have also applied the terms of the agreement to banks within their jurisdiction. In fact, however, the terms of the agreement are a good deal more precise than the language suggests. And the agreement secures commitments considerably more precise than any of the Committee's previous papers.[4]

Second, the agreement is concerned with ultimate objectives and not with details per se. That is to say, provided the objectives are assured, the Committee was quite content to allow these objectives to be achieved in whatever way individual members felt appropriate. That way the Committee was not obliged to require members to harmonize in detail their methods of supervision.

A flexible approach also has the advantage of permitting the agreement to be adapted and interpreted to meet changing circumstances quite quickly. Supervisors need to be able to respond to market developments and a much more rigid agreement would have considerably weakened supervisors' ability to ensure that the spirit of the agreement continues to be upheld.

A. The Objectives

Bankers and other observers have often defined the objective of the agreement as the levelling of an uneven playing-field. But in fact that was not the principal

4. *Editor's Note:* Although Mr. Hayward is not writing as a lawyer, he raises, in this article, issues of legal significance concerning the nature of this "evolving" rulemaking in the area of international bank supervision. Are these "rules" becoming "soft law," and will a more formal regulatory structure be required? *Cf.* Gold, *Strengthening the Soft Law of Exchange Arrangements,* 77 Am. J. Int'l L. 444 (1983).

end in sight; rather, it was the means of achieving a strengthening of the capital position of the international banking system. Systems of bank supervision have not been created to ensure fair play, but to ensure the safety and soundness of national banking systems and to protect the interests of depositors.[5]

Throughout the 1960s and 1970s, the forces of competition, particularly for international business, had tended to erode profit margins and therefore the ability of banks to raise capital levels commensurate with the rate of growth of their assets. Moreover, the need to maintain an adequate return on equity in the face of declining returns on assets had encouraged banks to allow their capital ratios to decline. In the 1980s, the international debt crisis cast considerable doubt on the value of a sizable component of bank assets. The principal objective of the agreement was, therefore, to counter what many perceived as a tendency for the capital strength of the banking system to become less adequate. The need felt by many supervisors to improve that strength could only be achieved by assuring the banks that their competitors in other countries would be required to achieve the same objectives. Indeed it was the overriding nature of this objective that allowed members to commit their authorities to surrender long-held and desirable aspects of their own supervisory systems in the interest of reaching agreement.

B. IMPLEMENTATION

The agreement is essentially in two parts: a system of measurement and a set of minimum standards. Implementation even of the measurement system is by no means yet complete. Even in those countries where the supervisory authority has a relatively free hand to amend its rules, changes of this sort take time. This is true, even where the changes required were less extensive. For a start, substantial alterations to the reporting requirements had to be set in place. These involved, particularly in the case of off-balance-sheet transactions, collection of a large amount of data that most supervisors had never collected before. It was therefore necessary to enter into a dialogue with the banks as to the most effective way the necessary information could be collected and presented. A good deal was and is being learned by banks and supervisors of the nature of the risks being measured in the process. In some countries this process was complete by the end of 1989, but in others it is taking rather longer.

For countries where the banking legislation itself lays down in detail the arithmetic for the calculation of solvency requirements, the process is necessarily more protracted. And in some cases amendment of the legislation has only been possible in the context of other reforms where the political interest, and therefore the likelihood of delay, is even greater. In addition, member countries of the

5. *See* Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities*, OHIO ST. L.J. (Special Symposium, Winter 1989).

European Community (EC) had been engaged in parallel negotiations as part of the "1992" arrangements. These were not concluded until early in 1990, when members finally agreed on the minimum requirements to which those countries should adhere, having wisely delayed finalization until the discussions in Basle had been concluded. Several member countries understandably felt it would be preferable not to change their own national rules until both sets of negotiations had been completed. However, as we shall see, these delays to the implementation process do not appear to have held up the process of adjustment.

The second aspect of implementation has been the attainment of certain minimum standards. In view of the ground to be covered by a number of banks, a transitional period running up to the end of 1992 was allowed, with an interim target to be reached by the end of 1990. The market has in fact tended to shorten this transitional period. Indeed, preliminary results suggest the banks are making faster progress towards the target minimum standards than many had believed possible when the targets were first agreed in 1987.

C. Significance for the Committee

There is no doubt that the capital agreement marked a quantum jump for the Committee's role as a joint decision-making body. Previously, the Committee's role had been largely a forum for the exchange of information, and a place where supervisors could learn from each other and develop codes of best practice. Even the Concordat which, by attributing responsibility for the various aspects of a bank's international business, sought to ensure there were no gaps in the supervisory system, and the Committee's paper on consolidation, which was part of the same process, were but guidelines. The intention was that those supervisors with inadequate or deficient powers could over time seek to make the necessary changes. Meanwhile, at least a supervisor in one country would be aware of the limits to the powers of a supervisor in another. This is by no means to belittle the achievements of the first decade or so of the Committee's existence. Before the Committee was established, international cooperation of course existed, but was very much ad hoc. By the end of that period it was a permanent feature of the life of all supervisory authorities with responsibility for banks operating internationally.[6]

Nevertheless, the capital agreement went much further. The discussions leading up to it were much more in the way of negotiations because the participants were aware that, at the end of the day, they would be expected to commit themselves to ensuring that their own rules and procedures were fully consistent with the outcome. Although not legally enforceable as a treaty, and although the Committee is not a formally constituted international organization, nonetheless the

6. *See* Norton, *supra* note 2.

agreement is considered to be binding on the members and the agreement itself states that the Committee will continually monitor its application.

Some feared that this process could change the character of the Committee and that members would be reluctant to be as open and as frank as they had been in the past. Moreover, as negotiators on behalf of their institutions, they might be reluctant to contribute to the debate unless they were sure that their expressions of view were capable of being, and had been, fully authorized at the appropriate level by the institution they represented.

To some extent this fear has been borne out and the negotiations on the capital agreement were extremely tough. But in other discussions members have been just as frank, in part at least because members of the Committee have a good deal of personal confidence in each other. In part, the process is helped because much of the consensus building takes place in informal working groups where the process of mutual education is allowed full rein. Thus, when the recommendations of such groups come before the full Committee and more formal discussion takes place, there is considerably less scope for misunderstandings and discussions are normally extremely fruitful.

The very informality of the language of the agreement has been a factor here too. At the beginning there was a fear that banks would seek to abide by the letter of the agreement but not necessarily by the spirit. Members of the Committee were alive to the danger that, if this were possible in one country, other supervisors would be under strong pressure to make similar concessions to banks under their jurisdiction. The fear that the agreement might then unravel was a powerful factor. Procedures were set up so that members could bring problems to the Committee at an early stage and agree on a joint response. Moreover, the Committee went further and, in the face of ingenious proposals by banks and their advisers, took some tough and arbitrary decisions in order to avoid establishing precedents that could lead the Committee down a slippery slope. In effect, the primary objective of strengthening the capital of international banks, both in qualitative as well as quantitative terms, took precedence over the letter of the agreement. Such a robust attitude might have been much more difficult to enforce had the form of the agreement been such as to encourage quasi-litigation.

D. Significance for Members

The existence of the Committee and the commitments that members undertake there has undoubtedly affected the way supervisory authorities operate within their own jurisdiction. Although many decisions that members take have purely domestic implications, in an increasing proportion of cases the globalization of the marketplace has meant that a decision in one country has implications for banks and their supervisors elsewhere. Supervisors, therefore, need to be aware of these implications, and the Committee provides a forum where they can be discussed. In theory, this constraint could lead to legal conflicts but, in most

countries now, the legal framework for the supervision of banks allows for consultation with other supervisory authorities and indeed permits the exchange of prudential information with the other supervisory authorities in countries where banks have foreign establishments. Undoubtedly, the supervision of banks is more complex than it was, but a supervisory authority's membership of the Committee, although not without cost, has sufficient benefits to outweigh that cost.

E. Implication for Other Supervisors

Although the capital agreement, and indeed other documents produced by the Committee, are addressed to its members, that is, the bank supervisory authorities in the Group of Ten countries and Luxembourg, its work has very significant implications for supervisory authorities in the many other countries in the world with banks operating internationally.

The Committee could have reacted to this need by setting up an international organization that such supervisory authorities could have been invited to join. This would have been a cumbersome solution involving a great deal of work and expense, both in the organization itself and for its members. For example, legislation would probably have been necessary in most countries, thus adding a political dimension to what is now principally a technical activity. As effective a solution has been found by adopting a number of more practical measures.

The first was to encourage the establishment of a number of regional groupings of supervisory authorities. Some of these, of course, would have come about without the Committee's involvement and in two cases they predated the Committee. The first, a grouping of supervisors from the Nordic countries, goes back to the 1920s. Much more recently, but still before the Committee's establishment, the European Community's supervisors set up a so-called "Groupe de Contact." Cooperation in the European Community has developed significantly since then and will take a further step forward with the coming into force, at the end of 1992, of the Second Banking Co-ordination Directive. By that time all Community banks will have the right to provide services, including the right to establish branches throughout the Community. This means that bank supervisors must give automatic right of establishment to a branch of a bank supervised by another Community supervisory authority. So, in effect, the host supervisor cedes his authority to that of the supervisor in the country where the bank is incorporated. EC members are prepared to do this because they have agreed to mutually acceptable minimum standards of supervision incorporating the capital adequacy framework agreed in Basle.[7]

More recently still, groupings in the Caribbean, Latin America, Asia, and the Middle East have been established, and at least one meeting of African super-

7. *See generally* 1992: THE IMPLICATIONS FOR THE BANKING INDUSTRY (2d ed., R. Cranston ed.) (to be published in Winter 1990 by Lloyd's Publications, London).

visors has been held. The Chairman and members of the Committee have often been invited to attend meetings of these groups and there is a continual exchange of information at the working level.[8]

Secondly, beginning in 1979, a series of international conferences has been held to which virtually all supervisory authorities have been invited; over one hundred countries have been represented at these meetings. These conferences provide a good opportunity for members of the Committee to be exposed to the views of other supervisors and vice versa.

Thirdly, the Committee through its small permanent Secretariat in Basle, has circulated the Committee's papers to all known supervisory authorities, organized training seminars, and handled an increasing number of inquiries from supervisors all over the world.[9]

Through these various methods, therefore, the Committee has ensured that the means for wider international cooperation exists. But, of course, it is one thing for the channels to be there; they have to be used.

Right from its earliest years the Committee has endeavored to persuade all countries to adhere to the Concordat and to adapt their regulatory environment to the requirements that the division of responsibility enshrined in the Concordat demands.[10] Essentially this involves amending confidentiality rules so that supervisory authorities can communicate with the authorities in the other countries in which a particular bank operates. A more detailed supplement to the Concordat has recently been agreed, dealing specifically with the exchange of prudential information, the relative rights and obligations of host and parent supervisors, and the safeguards and constraints necessary to ensure that the principles of the Concordat are properly implemented.

Similarly, the 1988 capital agreement has been recommended to the supervisory authorities in other countries with international banks. Most such countries have adopted, or are in the process of adopting the agreement, in some cases with modifications to suit their own marketplace. The result is that there are few banks operating internationally that are not now subject to the same set of minimum standards of capital adequacy. This is an achievement comparable with that of many long-standing international organizations with far more extensive formal powers. Indeed, some have claimed that banking is the only industry subject to effective regulation on a worldwide basis.

F. Implications for the Banking System

But it is the implications for the market in financial services and its users that is the most important aspect of international cooperation between banking

8. *See* Basle Supervisors Committee, Report on International Developments in Banking Supervision, No. 6, Part IX (Sept. 1988) [hereinafter Report].

9. *See* Norton, *supra* note 2.

10. For a copy of the Revised Concordat, see 11 I.L.M. 900 (1983).

supervisors. The 1988 capital agreement has clearly had a much more visible and immediate impact on the way that banks operate than any previous cooperative effort by supervisors, although in the long run the understanding on the respective roles of supervisors that underlies the earlier Concordat may have had a more important effect by containing problems which might otherwise have had deleterious effects on the international banking system as a whole.

As has already been stated, the purpose of the capital agreement was to strengthen the capital base of the banking system; in other words, a modification in banks' behavior was the point of the exercise. It is interesting to note here the rapidity with which the banks have reacted to publication of the proposals. Because in some countries the adjustments required were very substantial, a relatively long transitional period of five years (or about four-and-a-half years after the final version of the agreement was published) was felt necessary. But as evidence of the desire of the Committee to keep the pressure up, interim standards that had to be reached by the end of 1990 were incorporated. However, it is already clear that banks have come under increasing pressure in the marketplace to advance the pace of adjustment. Banking depends on confidence, and many banks have felt that, by demonstrating that their capital position is stronger than the minimum level demanded by the supervisors, their position in the market is enhanced. The attention given to the agreement in the press and the market has therefore tended to compress the transitional period allowed in the agreement itself, and fortified the efforts of the supervisors. Certainly, the agreement has drawn greater attention to the need for banks to have adequate capital and the market itself has therefore become more demanding in dictating what is regarded as adequate.

In addition, apart from the need to make greater provisions for earlier lending to countries that have faced difficulties in meeting their obligations, the period since the agreement was signed has been a profitable one in most countries. This has meant that banks have been able to enhance their capital by significant profit retentions and to raise new capital in the market on reasonable terms. Rising stock markets, especially in Japan, have also meant that a substantial increase in new issues of bank capital has been possible without a damaging effect on bank stock prices and therefore on the cost of that capital.

A great deal of attention has been paid to the equality of competition that the agreement has achieved or failed to achieve. As has already been stated, competitive equality was not the main objective and indeed could not be. A number of factors to a varying extent outside the control of bank supervisors are just as relevant to the ability of banks to compete on equal terms as capital adequacy requirements. Tax is a particularly crucial factor and, although the supervisors may have some influence in certain areas, for example, the treatment of provisions, insofar as banks are taxed on the same basis as other corporations, their influence may be quite limited. Similarly, accounting conventions used in banks are normally based on those in use for all corporations and thus are outside the

influence of supervisors. There are significant differences of treatment of, for example, the valuation of assets. In some countries, companies, including banks, are expected to value their assets at market value. These can include assets not held for trading purposes, such as fixed assets employed in the business, including bank premises. In other countries, assets are valued at historic cost, or at cost less any permanent diminution in value. For a bank, such alternative accounting can imply major differences in net worth. The structure of the domestic banking system and the degree of permissible competition are again often the subject of primary legislation, and the supervisor may only be one of several influences in their evolution. Finally, the cost of bank capital depends not only on the profitability of each country's banking sector but on the overall cost of capital in the economy. Thus, Japanese banks, for example, have a considerable advantage over banks from other countries, where earnings yields for quoted companies are in general much higher.

Nevertheless, the agreement has highlighted these differences and to some extent encouraged banks to find solutions. For example, it is not now uncommon for banks to raise capital, admittedly only secondary capital, in markets other than their own. Moreover, the internationalization or globalization of banking has continued its inexorable path. And it is probably true that, to the extent that the capital agreement has levelled the playing-field, it has contributed to that process.

Of course, the implication of higher capital ratios is that banks will need to earn higher profits if they are to service the new capital that both the supervisors and the market are requiring them to raise. Certainly, one of the factors alarming supervisors in the 1970s and 1980s was the apparently never-ending erosion of margins of profitability, while the risks, if anything, appeared to be growing. It is perhaps too soon to say with much confidence that this process has been reversed. However, there are signs that the deterioration has at least been halted, although the recovery in bank profitability has probably taken place mainly in more protected domestic retail markets than in the market for international business.

II. Current Aspects of Cooperation

The capital agreement, of course, was not the end of the road. Although it marked a change of gear, the process of international cooperation continues. Much of the work currently under way is a continuation of the relatively unglamorous process of mutual understanding and the development of the means of communication, so that problems with international ramifications can be dealt with expeditiously. The Basle Committee is continuing to prepare papers on best supervisory practice in a number of areas for circulation to supervisory authorities worldwide. For example, work is being done on the concentration of credit risk, perhaps the most prevalent cause of bank failures, and on the systems of internal controls that banks with advanced computer systems need to have in place. This work demonstrates that capital adequacy requirements are but one of

the pillars of bank supervision and, in many cases, by no means the most important.

But the process of capital convergence nonetheless goes on. In the 1988 agreement there were a number of areas where the Committee was dissatisfied with the degree of convergence achieved and wished to continue its work. The most important of these relate to the definition of capital, in particular the inclusion by many countries of general or unallocated provisions or loan-loss reserves. Although the agreement allowed the inclusion of these elements, not all members were wholly convinced that they were truly available to meet losses wherever they might occur. In other words, there was a fear that such provisions were not wholly clean but could be contaminated, for example, in respect of country transfer risk. The Committee is committed to refining the definitions in this respect by the end of 1990, failing which this element of capital will be subject to a cap or ceiling.

Another aspect of growing importance is the treatment of "market" risks. The 1988 agreement confined itself in the main to the treatment of credit risk. The taking of credit risk is the principal risk in nearly all banks, even those more geared to wholesale markets. Nevertheless, all banks are capable of being exposed to other risks, particularly the risk of changes in market prices or rates that are not influenced by perceived changes in the credit-standing of a bank's counterparties. The most common, and the risk that has caused the greatest losses, is the risk that a change in the level of interest rates will affect the bank's income and indeed its net worth. This is a risk that all banks, large or small, tend to run. In less sophisticated times, it was almost an inevitable risk. Banks' borrowings normally have a shorter average maturity than their assets. If interest rates rise, earnings are depressed and, if assets have to be realized, so is a bank's net worth. Indeed, in many countries, such losses have often been quite pronounced, particularly in the 1960s and 1970s, when deregulation of deposit rates coincided with increased volatility of interest rates. The plight of institutions in the U.S. mortgage loan business is a particularly extreme example, but similar developments have occurred in many other countries. More recently, the spread of variable rate lending and the growing availability of liquid markets for interest rate futures, forward rate agreements, and options has provided an opportunity for banks to hedge the risk of such exposure. But more to the point, these markets now allow banks to expose themselves to risk quite deliberately, and such opportunities can now form the basis of a significant part of a bank's risk-taking activity.

Similar opportunities are present in the foreign exchange market. Whereas in the past foreign exchange positions had more often than not either been covered or arose temporarily out of transactions with customers, now banks are more actively seeking to make money by deliberately opening up foreign exchange positions. As with interest rate risk, the ready availability of increasingly liquid markets in derivative products make the taking of these positions that much easier.

Finally, banks are becoming increasingly involved in securities trading activities, whether on their own balance sheets or by setting up affiliates or by acquiring existing firms of securities dealers. Although there are credit risks involved here, very often the risks are as much related to the level of interest rates or, in the case of equities, to movements in the market as a whole. Moreover, there is some suggestion that national securities markets are behaving less independently than before.

The nature of market risk is, however, very different from credit risk. When a bank assumes a credit risk it normally anticipates a quantified but small gain, the net interest margin over the life of the loan plus any fees payable, and risks a much larger loss whose maximum extent is still ultimately quantifiable, that is the total amount of the loan or guarantee. With market risk, potential profit and loss are more nearly symmetrical and in theory almost limitless. Moreover, exposure to such risks can in many cases change much more rapidly than is normally the case with credit risk, particularly with the development of derivative markets.

For these reasons, and because of the complexity of the derivative products available for banks to hedge and take these risks, measurement of the amount of exposure is by no means as straightforward as it is for credit risk. Options are a particularly difficult feature, both for banks and for their supervisors. The Basle Committee has been studying these aspects for some time and has undertaken a number of trials with banks to see whether it would be possible to devise common systems of measurement that would be reasonably simple but yet accurate enough to form a satisfactory basis for prudential tools. Such tools might take the form of systems of limits, which some supervisors already use, or possibly the incorporation of capital requirements within the existing capital agreement. One of the problems has been the need to establish systems that are consistent with those used by bank managements themselves, particularly at a time when systems are changing and bankers themselves have differing views about the most effective way these risks should be managed.

Supervisors feel that supervisory methods need to be as consistent as possible with management control if they are to be understood by the banks and form the basis for effective supervision. It has not proved easy to devise instruments that are simple enough to form a common basis for supervision in all countries, yet are precise enough to track the risks sufficiently adequately.

III. Relations with Securities Regulators

International work on the supervision of market risk, particularly in the area of those risks involved in traded securities, has brought the banking supervisors in contact with the regulators of nonbank investment firms. In some countries, such as Germany and Switzerland, securities trading, both the issue and underwriting of securities in the primary market and their secondary market trading, are considered as banking business and require a banking license to be carried

out. In these countries, such "universal" banks are subject to one set of supervisors, who apply prudential requirements largely based on banking supervision techniques, although some banks within their jurisdiction do concentrate more on securities business than on conventional deposit taking or lending.

However, in other countries the bulk of securities trading business is carried on by nonbanking firms subject to separate regulatory requirements. This is true in Japan and the United States, where banking and securities dealings are legally separated (although banks in both countries are allowed to carry on government bond business and other forms of securities business in their overseas affiliates) and also in a number of other countries where traditionally securities business has been carried on in separate firms, although these may be, and increasingly are, owned by banks. In a few such countries banks may also now carry on securities business within the bank itself on the universal bank model.

Securities regulators have for a number of reasons felt less need for international cooperation than have banking supervisors. For a start, securities firms have until recently been organized in respect of a single market. Where they have opened establishments in other national markets, they have usually done so by establishing affiliates and not branches. Moreover, the regulators have often themselves either been organized stock exchange authorities or have delegated detailed regulation to the exchanges. Furthermore, their conventional way of dealing with a problem has been to reduce the firm's activities or, at the last resort, to close it down. The method of regulation has therefore been designed to ensure that firms did not engage in activities, such as the acquisition of assets not readily liquefiable, which would preclude a rapid repayment of a firm's creditors. As a result, securities regulators have not often seen the need for consolidated supervision.

However, the breaking down of conventional barriers between banking and securities trading has raised difficult questions of competition. All major international banks now carry on securities business, although in the United States and Japanese cases this is largely confined to government bonds and securities business in overseas markets. Moreover, the larger securities firms are increasingly wishing to carry on significant business more of a banking nature, such as foreign exchange, bridging loans, and swaps, in connection with the issue of securities and the provision of a service in the secondary market to their customers. Sometimes this is done by setting up affiliates with banking licenses and sometimes through affiliates that are not supervised at all.

Supervision of groups that include both banks and regulated securities firms has led to the need for an extension of the arrangements for the exchange of prudential information between banking supervisors to include at least the major securities regulators as well. But it is also leading to demands, both from banks and securities firms, for a more level playing-field, or at least the removal of rules that disadvantage one player in the market vis-à-vis another.

This process has led to a fundamental conflict. On the one hand, there are often sound prudential reasons why the method of supervision differs quite significantly between banks and securities firms. For example, securities regulators put a very severe penalty on the holding of assets that are not easily realizable, while banking assets are acknowledged to be liquefiable only on maturity. Banking supervisors for this reason require capital to be in a permanent form, while securities firms are allowed short-term capital provided it is not withdrawable so long as the assets are held that require it. On the other hand, as the overlap between banking and securities trading becomes ever more extensive, it becomes important to ensure that these differing regulatory régimes do not unnecessarily distort the market.

The growing internationalization of the securities industry has led to discussions on differing supervision régimes in IOSCO, the International Organization of Securities Commissions, and also of joint meetings of securities regulators from Group of Ten countries with the Basle Committee. No doubt these discussions will continue and develop as the need grows for the establishment of a framework for the supervision of financial groupings that include both banking and securities businesses throughout the world.

IV. Relations with Other Supervisors

Of course, there are other forms of financial intermediation where the boundaries are being crossed. One principal area is the writing of insurance. In many countries, insurance companies are undertaking activities close to banking, for example, selling policies that resemble long-term deposits and acquiring securities which resemble bank loans. In some countries, banks are acquiring insurance companies and vice versa. In all countries, insurance companies are regulated under separate legislation and according to quite different principles. Moreover, insurance regulators, like the regulators of securities firms, have not yet felt the need to adopt the principle of consolidation. Whereas bank supervisors no longer feel it is possible to rely on the corporate veil, and feel that a banking group would be bound to protect its good name if an affiliate were to come close to failure, most regulators of other intermediaries regard their responsibilities as extending only to the regulated entity.

It is probably safe to assume that the network of international cooperation will widen further in the future to take in insurance regulators, who have yet to come together in any international body, and, in those countries that have it, supervision of fund management and other intermediaries. There will still remain, however, the difficult question of the supervision of groups where the parent company is simply a holding company and is not, therefore, regulated. The only major country to supervise holding companies is the United States where bank holding companies are strictly limited to owning banks and subsidiaries conducting business closely related to banking. The differing ways in which financial

conglomerates exist in different markets, and their growing internationalization is bound, therefore, to require increasing cooperation in the years ahead.

V. Relations with Other International Organizations [11]

Mention has already been made of the fundamental differences that still exist in the way company accounts are prepared in different countries. With the growing internationalization of the capital markets, there are increasing pressures from investors and their agents to achieve some standardization of the way in which company accounts are presented. For some years, the International Accounting Standards Committee (IASC), on which are represented the accounting associations in most major countries, has been endeavoring to achieve progress in this area. Given the time necessary to reach agreement on accounting standards nationally, it is not surprising that this is a somewhat protracted process. The IASC has also been specifically working on the form of bank accounts and is also studying the treatment of new financial instruments. Although few bank supervisory authorities have responsibility for accounting matters, the Basle Committee has nevertheless maintained close contact with the IASC and supports its objectives.

Similarly, the Basle Committee has worked closely with the International Auditing Practices Committee (IAPC) of the International Federation of Accountants. The IAPC and the Basle Committee produced a joint paper on the relationship between auditors and supervisors and the IAPC has also produced a guideline on the special problems of auditing international commercial banks. The role of auditors varies considerably from country to country. In some countries, considerable reliance is placed by supervisors on auditors, who are asked to report to the supervisory authorities on particular aspects of a bank's procedures, for example, its internal controls and accounting records. In other countries, the responsibility of the auditor to the bank's shareholders is regarded as incompatible with the role of the supervisory authority. Nevertheless, in all countries, the adequacy of external audits is clearly an important factor in securing the sound management of banks, and the Committee is therefore keen to ensure high standards in this area.

VI. Conclusions

This brief survey is intended to describe the extent of international cooperation between bank supervisory authorities, the reasons why such cooperation has become necessary, and the prospects for cooperation in the future. For several centuries banks have operated internationally, whereas bank supervisors have been constrained by the limits to their legal jurisdictions. And attempts by gov-

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11. REPORT, *supra* note 8.

ernments and their agencies to apply their jurisdiction extraterritorially are always resented and resisted. The only way, therefore, to ensure effective supervision of the modern international banking group, with its plethora of branches, subsidiaries, affiliates, and investments, is by cooperation with the relevant supervisory authorities in the other jurisdictions involved. As the organization of banking groups becomes ever more complex, so necessarily does the need for cooperation grow. Moreover, such cooperation must now extend to supervisors and regulators of other financial intermediaries that, increasingly, are linked with banks. Although much of banking supervision can be directed solely at domestic operations of banks, the international dimension has become increasingly significant. Whereas in the European Community there is much talk of a single European market, for banks that market already exists; but, it is a global market transcending regional boundaries. Increasingly, supervisors must act jointly if they are to preserve the integrity and soundness of what has become a worldwide banking system.