

# INTERNATIONAL BANKING STABILITY AND BASLE COMMITTEE

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**Summary.** The article underlines the role the Basle Committee on Banking Supervision has in assuring the stability of international banking system. This role is more important as, nowadays, under the circumstances of emphasising the financial globalisation, the risk to transmit banking crisis from one country to another, from one region to another and, finally, on global level, is bigger and bigger.

## 1. Basle Committee – origins, members, objectives

If by the beginning of the 1970s the international banking stability was considered to be assured through measures taken exclusively on national level, the major banking crisis from 1974 requested some measures taken on international level. These measures aimed prevention and attenuation the negative effects of bank crisis on international level. In order to achieve these objectives the Basle Committee on Banking Supervision was created (called below Basle Committee or simply the Committee). From its creation until now, the documents released by the Committee have had an important contribution in establishing of prudential supervision rules both on national and international level.

The three big crises from 1974 which had an impact on international banking community were: Herstatt Bank crisis from Germany, Franklin National Bank crisis from USA and the British Israel Bank subsidiary crisis in London. In the first case, the Herstatt Bank bankruptcy produced serious problems on markets in the whole world and pointed out a new risk – the settlement risk, which, from that point, is known as Herstatt risk. The causes of this crisis were the very big loses caused by some speculative currency operations, hidden under false accountancy recordings. We have to mention also the fact that in that moment Herstatt was one of the biggest private banks in Federal Germany. As consequences of this crisis we can name trust diminishing among participants on international currency market and extending these precaution measures to the level of eurocurrency market.

**The Franklin National Bank**, willing to develop rapidly, adopted a less cautious financing policy, which affected the quality of assets. Unperformant loans and the numerous assets with low level of liquidity, together with a weak management and excessive short term financing threatened the bank to be declared insolvent. At that time, Franklin National Bank was one of the biggest banks in USA, which had ties with many banks abroad. Thus, its bankruptcy could have created important problems not only at the level of the USA banks, but also for the banks from other countries which, one way or another, were connected to Franklin National Bank. In order to avoid such a probability, the USA authorities supplied Franklin National Bank with all necessary funds it needed.

In the case of **British - Israel Bank** another problem came out, which requested its solution according to raising of the number of banks' foreign establishments. Once the bank closed, the authorities from Israel returned the deposits of the residents and the unresidents from all the local branches of the bank. The clients of the British Israel Bank subsidiary from London did not receive the money back. The justification of the Central Israel Bank was that the subsidiary in London had its own judicial personality and, consequently, was under control of the Bank of England. On the other hand, the Bank of England considered that it had no responsibility.

The bank crises mentioned above emphasised the fact that, once the international banking developed, the ties between banks in different countries increased; all these lead to a more vulnerable international banking system. In this context, some measures had to be taken that would prevent banking crisis on international level.

Consequently, in 1974 Basle Committee on Banking Supervision was created. The Committee's secretariat is located at the Bank for International Settlements. Initially, this Committee was composed of representatives of 12 countries - The Group of Ten (Belgium, Canada, France, Germany, Italy, Japan, Holand, Sweden, England and The USA), to which added Switzerland and Luxembourg. Beginning with 1st February 2001, Spain was attached to Basle Committee. Within the Committee, the member states are represented by central banks and the authorities in charge with prudential supervision, in the case in which this activity does not represent the responsibility of the central bank in that country.

The documents released by the Basle Committee do not have any legislative power. However, they have a powerful influence in establishing the legal frame regarding the prudential supervision in many countries of the world, including Romania, having a major contribution in harmonising banking agreements on international level. Also, the dissemination of the rules established within the Committee and their acceptance on international level is due to permanent cooperation between the Basle Committee and other supervision authorities, and also to international conferences regularly organised.

In order to reach their objectives, the Basle Committee drew up a series of documents which aimed:

- establishing some general principles for the supervision of banks' foreign establishments;
- establishing some international standards on capital adequacy;
- publishing some core principles for effective banking supervision.

Besides all these documents considered fundamental, the Committee's attention turned towards some other domanis of major interest, such as: credit risk management, operational risk management, enhancing bank transparency, identifying, assessing, managing and controlling the risk associated with electronic banking, management of interest rate risk, derivatives.

## **2. The supervision of banks' foreign establishments – principles, agreements, evolution**

One of the problems raised by banking crisis in 1974 was the need to sign some international agreements to name the supervision authority (from the origin country or from the host country) that must carry on the function of preventive supervision, respectively the lender of last resort. This problem appeared because of the increasing in the number of the banks' foreign establishments. In time, the agreements signed

within the Basle Committee have been modified and adapted to evolutions which took place on international level. Also, an important factor has been the necessity to cooperate between the supervision authorities from the host country and the supervision authorities from the origin country.

Essentially, the agreements regarding supervision of banks' foreign establishments established two fundamental principles:

- (1) no foreign banking establishment should escape supervision and
- (2) the supervision should be adequate.

In order to fulfill these objectives, the banks' foreign establishments were classified into three big groups: branches, subsidiaries and joint ventures or consortia. Also, sharing the responsibilities between authorities from the origin country and those in host country have been achieved taking into account the following aspects: liquidity, solvency and foreign exchange operations and positions.

The documents adopted emphasise the importance of permanent cooperation between supervision authorities from the origin countries and those from host country. At the same time, within the supervision of international banking, one can notice the tendency to affirm the principle of controlling from the origin country. Also, adopting an adequate supervision imposes adopting the principle of consolidated supervision. According to this principle, the supervisors from the origin country must monitor the exposure risk of the banks under their responsibility for all operations no matter the territory they are located. These principles are reflected in the document adopted in May 1983, entitled „**Principles for the supervision of banks' foreign establishments**”, also known as the Concordate from 1983.

The cooperation between supervisors from the origin country and supervisors from the host country was improved after adopting, in 1990, of the „**Information flows between banking supervisory authorities**” document, also called the **Supplement to the Concordat from 1983**. The document includes a series of recommendations to improve the informational flux between the two supervising authorities.

Improving the rules regarding international banking was realised in 1992 through the document „**Minimum Standards for the supervision of international banking groups and their cross-border establishments**”. The new adopted principles were:

- all international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision;
- in order to authorise the opening of a new foreign banking establishment, one must obtain the prior consent of both the host country supervisory authority and the home country supervisory authority;
- the supervisory authorities from the origin country have the right to obtain information from the foreign banking establishments that they control;
- in the case in which the supervisory authorities from the host country consider that the minimum standards established by the authorities from the origin country are not satisfactory, they may impose some more restrictive requests, in which to include the refusal to authorise functioning on its territory (Basle Committee, 1992, p. 22-26).

In October 1996, the Basle Committee, together with the Offshore Group of Banking Supervisors, produced a document – „**The supervision of cross-border banking**” -, which emphasised the problems regarding the implementation the minimum standards established in 1992 and suggested some practical solutions.

### 3. International standards regarding bank capital

Starting from the belief that only a bank system with a good capitalization can survive to bank crisis on international level, an extremely interesting domain for the Basle Committee was establishing some minimum capital requests for banks operating on international level. This action was determined by the fact that, willing to improve their profits, at the beginning of the 1980's, the banks which operated on international level were engaged in risky activities, which were not according to their own founds.

Taking into account the fact that the level of the international credit had risen, and the interdependencies between banks situated in different countries were becoming more important, this behaviour could affect the international banking system, the crisis of a bank could affect the whole international banking system.

After many consultations that have been started in the '80s, in July 1988, the Basle Committee published a report regarding the bank capital measurement and the capital standards entitled – **“International Convergence of Capital Measurement and Capital Standards”** – which is known in speciality literature as the 1988 Basle Capital Accord.

The main provisions of this Accord were referring to: defining the capital; establishment of risks weight for each type of bank activity and the calculation of the capital adequacy ratio. The bank capital is divided into: Tier One (shareholders' equity, disclosed reserves) and Tier Two (consisting of specified categories of reserves not eligible for inclusion in Tier One, hybrid financial instruments, subordinated term debt). The level of Tier Two is admitted up to a maximum value of 100% of the total of Tier One and the subordinated term debt cannot be more than 50% of Tier Two.

Depending on the risks that were implied, the banking activities were divided into four groups. Each group was assigned a risk weight: 0% for no risk activities, 20% for activities with minimum risk, 50% for the medium risk activities and 100% for highest risk activities.

In order to have a better correlation between the own funds and the investments made, the banks should have to maintain a minimum balance between the owned capital and the amount of assets on the basis of the risk weight. This ratio, known also as the capital adequacy ratio, should have a minimum level of 8%.

Although it had a great contribution to the improvement of banks capitalization and to the adjustment of own funds to their risk weight, the 1988 Basle Capital Accord had a series of **limitations** among which mention should be made of:

- the minimum capital requirements did not take into account all bank risks;
- assignment of risk weights was made without considering that the subjects belonging to the same group of counterparties are different;
- when calculating the capital adequacy ratio, there were not taken into account all the qualitative aspects regarding banking such as diversifying the portfolio or the stability of deposits;
- the 1988 Basle Capital Accord did not pay enough attention to the innovative methods for transferring risks.

The limits of the 1988 Accord and the evolution of the international banking have determined the Basle Committee to bring a series of improvements to the scheme of the capital adequacy and as a result of that, in June 2004 the final form of the new agreement was published. This new agreement is known under the official name of **“International Convergence of Capital Measurement and Capital Standards – a revised framework”**. In the speciality literature, this agreement is known under the

name of New Basle Accord, Basle II Accord or simpler Basle II. The Committee established the end of 2006 as the deadline for the implementation of this agreement. In case of more advanced approaches, the implementation was established for the end of 2007.

Starting from the premises that the stability of the financial system can be ensured through the coordinated action of three elements - efficient risk management, activity of the supervision authorities and the transparency of information regarding the bank activity -, the New Accord is based on three **pillars** (as they were named in the document drawn up by the Basle Committee):

- minimum capital requirements;
- prudent supervisory review process;
- market discipline.

**I. First pillar – minimum capital requirements.** In accordance with the New Basle Accord, the basic principles regarding the calculation of the minimum capital requirements as well as the defining of the own funds stay the same as in the previous version. At the same time, the minimum level of the ratio of the capital adequacy is kept at 8% and the additional capital is admitted up to a maximum value of 100% out of the basic capital. What has been revolutionarily modified was the calculation methodology of risk exposure and the introduction of the operational risk when calculating the capital adequacy ratio.

**(1) Minimum capital requirements for the credit risk**

In accordance with the New Basle Accord, in order to measure the credit risk, the banks can choose between two possibilities: a standardized approach and internal ratings based approach, previously approved by the national supervision authorities. These approaches make possible the risk assessment in a precise and diversified way thus allowing a better correlation of the minimum capital requirements with assumed risks.

**(a) The standardized approach** for credit risk measurement is similar to the approach used by the 1988 Accord but unlike it, is more flexible thus allowing a greater variety of risk weights corresponding to the same group of counterparts. This variety is possible by using the external ratings assigned by specialized institutions, recognized as eligible by the national supervision authorities. It should be emphasized that besides the four risk classes in the 1988 Accord (0%, 20%, 50%, and 100%), the New Basle Accord introduces the fifth risk class -150%- for the higher exposures.

**(b) The internal rating approach (IRB).** The credit risk measurement made by means of the internal rating approach represents beyond any doubt, one of the most important innovations brought to the New Basle Accord. According to this approach, the banks will no longer depend on the external rating agencies. On the contrary, based on the historical observations as well as on the probability mathematical approaches, they will establish by themselves the solvency of each client.

**(2) Minimum capital requirements for the operational risk**

Besides the minimum capital requirements for the credit risk and the market risk, the New Basle Accord suggests the measurement of the minimum capital risk requirements for the operational risk by using three approaches: a basic indicator approach, standardized approach and internal measurement approach.

**II. Second pillar – supervisory review process.** Besides the quantitative rules regarding the calculation of the minimum capital requirements states in Pillar 1, the architecture of the New Accord is based also on a set of qualitative rules meant to

ensure that between the own bank funds and the risks they assume, exists a corresponding correlation (Pillar2). To this purpose, the supervisory review exerted by the competent authorities will take into account, in a particular way, those risk factors which could not be quantified in mathematical formulas existing in Pillar 1, for instance quality of internal control systems.

**III. Third pillar – market discipline.** Besides the activity performed by the supervisors, Basle Committee considers that the market discipline namely the increase of the financial information transparency contributes to developing the correct risk management. In order for the participants in the market to have the possibility of checking the banks capacity to face some possible losses, they have to publish certain financial information.

#### **4. Principles of banking supervision**

Another major contribution of the Basle Committee was a set of principles, considered to be fundamental to ensure an efficient banking supervision. The document which includes these standards, called „**Core Principles for Effective Banking Supervision**”, was published in 1997, after a tight cooperation with authorities from outside the member states of the Committee. Also, this external cooperation is another proof of the fact that, permanently, the Basle Committee aimed that the documents it approved to be applied on a large scale.

We can appreciate that observing the 25 supervision principles underlined in the document drawn up by the Committee constitutes the basis premises for a healthy banking supervision in any country, no matter the degree of development. The experience has demonstrated that, in time, the supervision standards established in the document drawn up by the Committee represented an useful tool to assess the efficiency of the banking supervision in a country.

A confirmation in this matter constitutes the fact that the International Monetary Fund and the World Bank uses the supervision principles developed by the Basle Committee within The Financial Sector Assessment Program – FSAP, launched in 1999, following the emergent financial market crisis from the 1990's. The initiation of this programme was the consequence of the experience resulted from mentioned crisis, taking into account that the international financial flows have become more and more mobile. In this context, the general accepted opinion is that the stability of the international financial-banking system and preventing the crisis with global impact can be assured if the financial-banking systems of every country are accordingly supervised. In other words, as the process of financial globalisation emphasises, the problems that appear at the level of an inefficiently supervised banking system can rapidly spread on banking systems in other countries and can become a threat for the stability of the international banking system.

Besides other aspects, Reports on Observance of Standards and Codes in the financial domain drawn up by the IMF and the World Bank assess the way in which the member states make the banking supervision. Thus, the supervision principles drawn up by the Basle Committee represent reference points in evaluating the national supervision usage.

The developments which have been made in banking activity and the regulating of the banking system, the experience and last but not least the gaps regarding the supervision standards have determined the Basle Committee to adopt the new conditions. Thus, in October 2006, the Committee published the revised alternative of

the supervision principles established in 1997. The document which includes the supervision principles was accompanied by a detailed guide regarding the methodology of its practical use („**Core Principles Methodology**”). Thus, in the case of every fundamental principle several criteria were published which must be taken into account to establish whether the respective principle is observed or not.

The 25 principles can be grouped into several categories, according to the problems taken into consideration. They refer to:

- responsibilities and the objectives of the authorities within the supervision process;
- licensing criteria;
- major acquisitions and transfer of significant ownership;
- requests regarding prudential supervision (capital adequacy, risk management, credit risk, problem assets, provisions and reserves, large exposure, country and transfer risk, market risk, liquidity risk, operational risk, interest rate risk, internal control and audit, ethical and professional standards in the financial sector, preventing against using banks for criminal activities);
- supervision techniques and methods;
- revocation of banking licence;
- consolidated supervision;
- cooperation and exchange of information between home banking supervisors and host banking supervisors.

After naming the principles regarding effective banking supervision, the document drawn up by the Basle Committee underlines the fact that for an appropriate banking supervision, several conditions must be accomplished. They include: sound macroeconomic policies, well developed public infrastructure, effective market discipline, mechanisms for providing an appropriate level of systemic protection.

## **5. Conclusions**

Under the circumstances of increasing the financial globalisation process, the improvement of the stability of the international banking system can be achieved by adequate banking supervision. An important role in this regard has the Basle Committee on Banking Supervision, whose activity was focused on three main directions: formulating some principles regarding the supervision of banks' foreign establishments, developing some international standards concerning bank capital and formulating fundamental principles for effective banking supervision.

In order to achieve its aim, the Basle Committee permanently preoccupied to revise the documents and to adapt them to evolutions and changes within banking activity.

The documents drawn up by the Committee have no legislative power. However they have a large international recognition. They represent a reference point in establishing rules of banking supervision on national, regional and international level. In this context, in Romania, after 1990's, the regulations regarding banking supervision have been harmonized to rules from the Basle Committee documents.

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