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Where Do We Come From? Innovation and Regulatory Response in the Banking Industry Before the Crisis

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ABSTRACT
The architecture of the financial regulation after the crisis will be an evolution of what preceded it. The available alternatives for reformation at a certain point are limited by the existing institutions. This means, primarily, that history matters, and that decisionmaking at a certain moment is also limited by decisions and events that took place beforehand. Because of that, the exercise of analyzing "where we are heading to" only makes sense insofar as we can minimally understand "where we are coming from".

KEYWORDS
banking regulation; bank crisis; Basle Committee; regulatory dialectic

INTRODUCTION

José Eduardo Faria produced an interesting paper in which he discusses some "architectural features" that describe the erection of the international banking regulation "after the financial crisis".[1] The text describes five possible assumptions of that may be of such an architecture, and it suggests two central features which could supposedly be more likely. Among other virtues, the paper emphasizes doubts - rather than certainties, because these do not exist — about what may occur in the aftermath of the crisis. The discussion of law and regulation after the crisis is inevitably an exploratory task, which is something that has not escaped the perception of that notable author.

Nevertheless, one thing is certain: the development of financial regulation (and the law in general) after the crisis will be an evolution of what came before it: reform options available at any given time are limited by existing institutions. This means, first of all, that history matters, and that the decision-making at a given time is also limited by decisions and events that occurred *previously. Therefore, the exercise of analyzing "where we are heading to" only makes sense if we also minimally understand "where we came from". That is what this article is all about.*

Besides this introduction, I have split this review into eight sections. In section one, I describe briefly three key changes that have occurred in banking in recent decades. In the following sections, I discuss how the ways through which the evolution of the regulatory framework has been intertwined with those changes; sometimes as a cause, and sometimes as an effect. Section 2 presents an overview of the subject of regulatory responses to the internationalization of the banking business. Section 3 provides a general description of the work of the Basel Committee. Section 4 describes the dynamics of recurrent banking crisis and regulatory response. Sections 5 and 6 describe, respectively, the main features of the procedural and substantive rules set out by the Basel Committee. Section 7 examines the problem of legitimacy of the Basel Committee. Section 8 concludes.

1 The banking business evolution

The banking business has undergone at least three radical changes in the past decades. The first one was the obsolescence of the conventional criteria for distinguishing between types of financial institutions in the United States. Of particular importance was the undoing of the regulatory framework established in that country in 1933[2]*, which created a sharp division between commercial banking and investment banking. Although this division has only collapsed once in 2008, since the 1970s the distinction between commercial and investment bank had been losing strength; in fact, in 1999, it had become virtually irrelevant.*[3]

As the division between investment banking and commercial banking activity became increasingly porous, competition in the U.S. banking industry grew. In the wake of this process, U.S. banks were driven to seek new businesses in new geographic markets, "exporting" higher degrees of competition in the banking industry. As a result of this process, the competition in the banking industry worldwide got even fiercer.

Secondly, this increased competition has led many banks to seek ways to meet their losses of financial intermediation income with financial services income. Thus, off-balance transactions increased, especially securitizations. As recommended by the Basel Committee, banking regulators tried to reduce the overall "systemic risks", increasing the banks' minimum capital requirements. Nonetheless, this increase has eventually boosted the banking concentration worldwide. The industry has achieved a well-established position, and large banks were becoming increasingly "too big to fail", i.e., banks whose bankruptcy could drag the entire national economy, then the global economy, in a big domino effect. The implicit government guarantee that the big banks would not go bankrupt was one of the factors that increased their appetite for risk, and this is at the root of the current crisis.

The third change was the accelerated process of technological innovation, which, in turn, has laid the technical foundations that have allowed both the online interconnection of world banking markets, and the fast pace of financial innovation - which is the systematic process of *using new instruments, institutions and operational policies that determine the structure of the financial system. Innovations occur through the use of new securities, new products and services and organizational forms. Each financial innovation poses a challenge to the regulator, and to the law in general.*

Taken together, these three changes show a dialectical process of provocation and mutual response between private agents and government. Constant innovation was part of a cyclical dynamics in which private agents acted creatively in order to escape the limitations imposed by regulators, generating a countermovement by the authorities to impose limits on private agents. The countermovement of the regulators was never complete enough to dramatically reduce the risks of the banking industry; this reduction, it was assumed, would always be associated with the reduction of credit supply and, therefore, the slackening of the economic activity pace. So, this new regulation derived an innovation among market agents. This means, among other things, that the very existence of regulatory limits has created strong incentives for the agents then bound by such limits to seek innovations.

It is easy to see this dialectic dynamics in the global financial crisis through which the world is currently undergoing. The mortgage crisis the U.S. did not begin in the banking system center, but in the so-called non-banking system. This brings together institutions that do not receive deposits from the public, such as mortgage companies, hedge funds, brokerage firms and investment banks. The epicenter of the mortgage crisis also featured insurers, particularly while performing activities involving either insurance or investment in securities (particularly the so-called credit default swaps). So far, the non-banking system has been under what is conventionally called the light regulation system.

On the other hand, this does not mean that the lack of regulation in certain aspects of the U.S. banking activity has not contributed to the crisis. Tolerance to very high levels of leverage of banks and lack of minimal parameters in the supply of credit to mortgages are probably the two most obvious aspects of omissions from U.S. regulators.

But the US downturn has not only triggered by government regulatory omissions..[4] *The U.S. government has implemented a range of policies specifically designed to promote subprime mortgages (riskier financing facilities). Particularly important was the role played by 'quasi-public' firms of housing finance in the U.S. (Fannie Mae and Freddie Mac)*[5] *which were under strong political pressure to feed the low-income housing market. Together, these two companies accounted for nearly 70% of the mortgage market in the U.S..*[6]

Poor banking management and the outbreak of the crisis were also associated with an extremely low level of basic interest in the United States. The real interest rate has even hit levels below the inflation rate during certain periods, particularly between 2002 and 2005, increasing the supply of resources that supported the rise of the housing bubble. The regulations that prevented pension funds and insurance companies to participate as bank shareholders also contributed to the crisis. To safeguard the financial health of pension funds and insurance companies, these rules had the side effect of preventing that investors interested in long-term gains from interfering in the management of banks. This scenario caused bankers to seek short-term *gains at the expense of quality of transactions over time. Furthermore, there was the classic problem of the bank bailout, that is, the doctrine of 'too big to fail', which gives incentives for major bank lenders to take higher risks since they operate under the implicit guarantee that banks will never bankrupt and will always be bailed out by the government.*

2 International banking and regulatory answers

Banking has four dimensions that matter to the regulation and law in general: (A) corporate structures and organizations of business control, (b) physical structures, (c) customers and creditors and (d) products.[7] International banking occurs when any of these dimensions involves more than one country. Until mid-twentieth century, international banking activities were relatively uncommon. Both corporate structures and organizations of business control, and physical structures, customers and creditors and banking products — were all often within a single country. In recent decades, however, this situation has changed dramatically. International banking transactions have ceased be an exception and have become the rule.

Driven by reduced of large-scale wars, expansion of international trade, advances in information technology, deregulation, diversification of banking products and banking innovations in general, international banking transactions have grown steeply in recent decades. On the one hand, this global expansion has enabled economic agents to diversify risk, extend credit and reduce prices for consumers, on the other hand, it increased the risk of financial "contagion", the so-called "systemic risk".

The regulation followed the globalization of the banking industry through two multilateral simultaneous movements. The first movement was political, and it essentially failed. The second one was bureaucratic, and (at least until the outbreak of the crisis) has had some success.

In the period after the 2nd World War, the national governments, to some extent, tried - but finally gave up - to sign comprehensive political treaties for international regulation.

The first and most important attempt to establish a comprehensive scheme of banking regulation came in 1947 with the discussion of the Havana Charter[8], which failed, as well as subsequent attempts to resurrect the idea have equally failed.

The major impediment to multilateral political efforts lay in the fact that, in general, those countries refused to give up their sovereign powers to regulate banks operating in their jurisdictions. This is largely explained by the fact that banking crises impose high political costs, which are unbearable for most political leaders. Moreover, banks had historically worked mainly in financing domestic businesses. Furthermore, in the postwar period, banking was still largely in the hands of governments with which the issue of regulation of private activities could be conveniently postponed. Thus, despite the internationalization of the banking industry, the direct regulation of international banking operations remained essentially national.

That has given rise to a system in which national regulators attached to the principle of territoriality of regulation were faced with the outlandish challenge of having to regulate increasingly internationalized banking transactions. The improvement of information technology *systems made it possible for banks to exploit weaknesses in the international regulatory system, especially by creating complex corporate structures to escape the regulation of a particular country or to undertake risky operations in more benevolent regulatory jurisdictions. With financial markets increasingly internationalized and interconnected, it became increasingly difficult to deal consistently with the so-called "systemic risk", which is essentially the risk that the failure of a financial agent will lead to a domino effect that topples the rest.*

In the absence of treaties and international institutions, national regulators have been articulated and established informal networks for exchanging ideas and experiences, coordinating efforts, and articulating common regulatory parameters at the international level. In the vacuum left by the inaction of politicians, the bureaucrats stepped in.

3 The Basle Committee

Until the mid-1970s, there was no international body responsible for promoting coordination among the various national banking regulators.[9] *In 1974, however, the central bankers of the G-10*[10] *and Luxembourg decided to set up the Basel Committee.*[11] *Unlike the IMF and World Bank, the Basel Committee does not have the status of international organization and operates in a very informal manner. It has no formal bylaws or its own physical facilities, and its funding mechanisms are flexible and variable. The Committee does not have its own staff; its main department is composed of professionals borrowed from central banks of member countries to the Bank for International Settlements, BIS.*[12]

Originally, the Basel Committee was conceived with a purely dialogic proposal, that is, it was intended to work as a venue for discussions and exchange of information and experience among the central banks of developed countries regarding the supervision of banks operating at multinational levels. Those aspects that could be more properly called regulatory *of such Committee have emerged gradually. It gradually moved away from exchanges of information and turned its attention to the promotion of international convergence of supervisory practices in banking.*

Always published in the form of recommendations, the decisions of the Basel Committee have been gradually becoming a typical case of soft law, as it is called in Public International Law. Soft law, in general, are the rules laid down in instruments with no legally binding effect, however, it can produce indirect legal effects, mainly influencing rulemaking processes in different countries.

It is true that the effects of these recommendations often vary between recipients. For the bureaucracies in rich countries, particularly members of the G-10, these recommendations in practice had a quasi-binding nature, and were followed very closely. For the bureaucracies of other countries, these recommendations were put forward as best practices or models, and integrate into the national legal systems of those countries, but not always in a uniform manner. This is why some authors have gone as far as to suggest that the Basel recommendations have a dual character: they are allegedly hard law for the rich countries and soft law for the others.

Actually, the models of good practice established by the Basel Committee, were little by little perceived as being true international regulatory guidelines, which could serve to give a sense *of coordination to the regulatory reforms implemented in several countries. In many places, the recommendations of the Basel Committee began to be truly decisive in the process of regulatory reform. In Brazil, for example, the effects of the Basel recommendations are perceptible; the dramatic changes implemented since the mid-1990s often mirror these recommendations with remarkable accuracy.*[13]

4 THE BANKING CRISIS DYNAMICS AND REGULATORY RESPONSE

The setup of the Basel Committee - in 1974, after the domino bankruptcy of three banks — and much of its most important recommendations have emerged in general in response to banking crises. The first major bank to fall was the Herstatt Bankhaus, from the then West Germany.[14] *Soon after that, the Israel-British Bank of London went bankrupt, driving the bankruptcy, a few months later, of the U.S. Franklin National Bank. These bankruptcies have generated the political consensus that banking stability would depend on a global effort rather than only on isolated activities of national regulators.*

The initial efforts of the Basel Committee focused on the coordination of multi-state regulation. This means that, at the beginning, its main guidelines were of a procedural nature. By then, principles that could orchestrate the cooperation and coordination between national regulators in several states were sought. Then, the first major decision of the Basel Committee was born, the "Concordat of 1975".[15] *That document was called "Concordat" precisely just to indicate that it had the force of a treaty, an instrument that is typical of relations between countries in the sphere of public international law. Its core purpose was to establish the principle that no bank could escape the banking supervision.*

A new banking crisis — this time, the bankruptcy of the Italian bank Banco Ambrosiano, *in 1982*[16] *— led to an amendment to the Concordat. Completed in 1983*[17]*, this amendment incorporated the principle of consolidated supervision as a core regulatory technique for international banking groups and established the principle of dual key supervision, under which regulators in the home country are encouraged to assess the quality of banking supervision in the host country and vice-versa..*[18]

Since 1988, the Basel Committee has also established guidelines of a substantial nature, i.e., their recommendations began to incorporate specific regulatory parameters and techniques to improve and (to some extent) harmonize standards and practices of banking regulation around the world. These guidelines include the so-called Basel Accord, which determined the regulation of credit risk based on the system of risk-weighted assets in the portfolio.

A new banking crisis arising from the collapse of the Bank of Credit and Commerce International (BCCI) eventually led to new changes in the guidelines of the Basel Committee.[19] *In response to the scandal, in 1992 the Basel Committee established the so-called Minimum Standards for banking supervision, combining elements of a procedural nature with others of a substantial nature. The document stated that all international banking groups should be supervised by a home country authority that was capable of undertaking a consolidated supervision of* *financial groups. It also established that the opening of overseas businesses (branches, subsidiaries or partnerships) would depend on seeking permission from both the "home" banking authorities and from the "host" banking authorities.*

In 1995, the Barings Bank of London bankrupted; in 1996, massive frauds perpetrated by the New York branch of Daiwa Bank were unveiled. This gave rise to a repetition of the old standard of publishing tighter recommendations in response to bank frauds of international proportions. In 1997 the Basel Committee published the Core Principles for Effective Banking Supervision[20] *to establish general guidelines for the improvement of banking regulation, particularly in developing countries.*

In 2001, the Basel Accord of 1988 was amended by the Basel Accord II, which sought to refine the rules of capital allocation, providing different treatments to the credit risk and operational risk of banks, seeking to fill any gaps that could lead to regulatory "arbitration". Then, a number of other guidelines of substantial character, usually with a strong impact on the attitudes of regulators nationwide, have come out.

Just to mention some of the most relevant documents, it is worth noting: the Consolidated KYC Risk Management (2004)[21]*, which established parameters of know-your-customer to be followed by the banking industry globally; Credit Risk Transfer (2005), which established parameters for the regulatory instruments of transfer and securitization of risks — with the current crisis, it is no surprise that the document is currently being amended, as discussed in the Credit Risk Transfer (Developments from 2005 to 2007) Consultative Document, July 2008 — and the amendment of the Core Principles for Effective Banking Supervision (2006), which aimed at, inter alia, aligning the principles of prudential banking regulation with the parameters generally applicable to the regulation of stock market and insurance. In addition, the Basel Accord II was amended again, and in 2006, a compilation of all amendments was published..*[22] *There is a number of documents dealing with accounting details for the implementation of the Basel Accord II.*[23]

5 PROCEDURAL RULES OF THE BASEL COMMITTEE

Altogether, the procedural guidelines issued by the Basel Committee are primarily concerned with aligning the activities of local regulators to those of the regulator where a foreign bank is based. The focus is, therefore, the activities of foreign subsidiaries and branches, and joint ventures between banks in more than one country. The division of responsibilities between home country and host country regulators is made according to general issues such as liquidity, solvency and foreign exchange transactions.

The Concordat of 1975[24] *established the principle that no banking institution could escape the banking supervision and that supervision should be appropriate. It also established that the regulation of international banking, in general, should be the joint responsibility of host country and home country regulatory authorities. However, it divided some of the regulatory powers.*

As for regulation of banking liquidity, the primary responsibility falls to the host country. That is because foreign banks generally follow local practices (from the host country) for liquidity management, and follow local rules and procedures applicable to their operations. As for the regulation of the solvency of financial institutions, the primary responsibility would depend on the type of banking institution concerned: supervising the solvency of branches would be the primary responsibility of the home country, and supervising the solvency of the subsidiaries and joint ventures would be the responsibility of the host country.

Finally, regarding the regulation of foreign exchange transactions, the Concordat of 1975 noted the existence of a diversity of purposes of regulation. The foreign exchange positions of banks could be regulated for three reasons: prudential regulation, balance of payments and foreign exchange market organization. The Concordat of 1975 established that prudential regulation would be a joint responsibility of the host and home country, while the regulation towards the other two goals would be the sole responsibility of the host country.

Some years later, the Concordat of 1975 was amended, resulting in the Amended Concordat of 1983. This amendment aimed to fill some gaps left previously, and establish the principle of consolidated supervision. This principle states that the regulator in whose jurisdiction the bank holding is based (i.e., the home country) should regulate the risk exposure and capital adequacy in relation to all banking operations carried out directly or through branches, subsidiaries or joint ventures, anywhere in the world.

Concerning the division of regulatory powers, the Amended Concordat of 1983 maintained the principle that supervision would be, in general, a joint responsibility shared by the host and home country. Nonetheless, the primary responsibility for regulating liquidity and solvency has changed in some cases. While the primary responsibility for overseeing the liquidity of branches and subsidiaries has remained under the host country, the primary responsibility for overseeing the liquidity of joint ventures was transferred to the country where the joint venture has been incorporated (i.e., created).

Regarding the supervision of solvency, the Amended Concordat of 1983 maintained the principle that supervision of the solvency of branches would be the primary responsibility of the home country. However, it has eliminated the concept that the host country would be primarily responsible for supervising the solvency of subsidiaries. Hence, the supervision of the solvency of subsidiaries began to be treated as joint responsibility of home and host countries. Moreover, the primary responsibility for regulating the solvency of the joint ventures began to fall on the country of incorporation.

The Amendment of 1983, however, recognized that, depending on the corporate structure of the joint venture, there could be some circumstances in which the responsibility for supervising the solvency would fall on the host country authorities and on the authorities based on the domicile of the controlling shareholder. Finally, no significant changes regarding the division of powers to regulate foreign exchange transactions between home and host country were found.

In general, the criteria for division of powers established in the 1983 Amendment have been in effect until today. It is true that the Basel Committee has always recognized that these *three aspects (liquidity, solvency and foreign exchange exposure) have many points of contact — in particular, the regulation of liquidity impacts the very solvency regulation. Furthermore, the determination of exchange exposure limits is closely linked to protecting solvency and liquidity. That is why, in practice, the distribution of powers outlined in the Concordats of 1975 and 1983 has become somewhat blurred.*

6 Substantive rules of the Basel Committee

Neither the Concordat of 1975 nor its amendment of 1983 addressed the substantive criteria to enable the adjustment of the banking supervision. Both were limited to establishing that these criteria should be set by the host country and by the home country according to their relevant powers. The design of objective criteria came as late as in 1988 with the Basel Accord, and in 1992, with the so-called Minimum Standards of Banking Supervision.

In subsequent years, the Minimum Standards were revisited and complemented in a broad effort not limited to the G-10. Other fifteen nations were involved in the design of the Minimum Standards. These included major emerging economies like India, China, Russia and Brazil. In 1997, the final document called the Core Principles for Effective Banking Supervision was published. This document established 25 principles for banking regulation, and was endorsed by the Brazilian Government; Brazil was not involved in the amendment of the principles in 2006. Because of that, it was not formally endorsed by our country. Yet, the amendments made in 2006 were relatively few.

The substantive principles of regulation contained in the Core Principles for Effective Banking Supervision deal with seven different categories of problems in banking regulation: (I) requirements for effective banking supervision (Principle 1)[25], (ii) authorizations and structures (principles 2-5)[26], (iii) prudential regulation (principles 6 — 15)[27], (iv) methods for the current banking supervision (Principles 16-20)[28], (v) information requirements (principles 21)[29], (vi) formal powers of supervisors (principles 22)[30], (vii) foreign banks (principles 23-25).[31]

As for the regulatory technique, we can distinguish two types of provisions in the Core Principles. Some principles provide specific contents for the rules to be issued by national regulators. For instance, the activities that financial institutions are allowed to perform must be clearly defined and the use of the word "bank" must be controlled (principle 2); the banking regulator should be empowered to review and reject proposals to transfer corporate control of banks (principle 3); the banking regulator should regulate bank's capital adequacy based on the rules of the Basel Accord (principle 6).

There is a second type of provision in the Core Principles which set goals to be pursued only by regulators, without determining requirements or specific contents. This is particularly true as regards the establishment of risk control systems, which should be designed by the banks themselves. Thus, banking regulators should regulate and supervise such that "they are satisfied"[32] that banks have adequate systems for evaluating credit risk (principle 8), sovereign risk (principle 12); market risk (principle 13); liquidity risk (principle 14); operational risk (principle 15). In addition to risk *management and assessment, the same technique applies to other regulatory areas such as internal controls (principle 17) and know-your-customer (principle 18), among others.*

The Core Principles provide guidelines for the prudential regulation in a broad way, and its impact on regulatory changes around the world has been relevant. Despite this, it is argued that different areas should to be treated in more detail and there are still gaps. These gaps are found in loan classification and accounting rules, particularly regarding the creation of a checklist to standardize the criteria for credit assessment.

The current banking crisis may well galvanize the various political forces necessary to produce a political consensus that will lead to the implementation of further reforms on these and other issues. The establishment of substantial criteria for regulation at the international level has been, as we see, an ever-changing theme.

7 The democratic deficit and procedural legitimacy

The progressive increase in political clout, at an international level, of Basel Committee decisions was reflected, among other things, in their own language adopted by the Committee in its recommendations. For example, the Basel Accord of 1988, which recommended the adoption of a banking capitalization system based on the risk of their assets, provided: "[...] each country will decide on how their supervisors will introduce and implement these recommendations on their different legal structures and supervising institutions".[33] Spearheaded by the broad and rapid implementation of the asset risk-based capitalization system worldwide, and the growing political clout of the Committee in general, the new Basel Accord of 2004 could be much more assertive (not to say rulemaker). Addressing the same issue of implementation of its decisions, it only stated that "[...] the New Accord will be applied on consolidated grounds to internationally active banks" (emphasis added).[34]

Anyway, a little-noted aspect of the internationalization of banking regulation in recent decades lies in the form, *rather than in the* content *of the recommendations of the Basel Committee. The process of internationalizing the banking regulation occurred without any need for passing major laws in Congress, nor any treaties pompously signed by heads of state, let alone proxies to international organizations.[35] The initial momentum is on informal arrangements that began to take institutional shape, political clout and legal importance.*

The eminently technocratic basis of the recommendations of the Basel Committee became, little by little, a tool for challenging the international legitimacy of their recommendations. In response, the Committee was gradually experiencing changes in deliberative procedures. Firstly, the Basel Committee increased the number of members; Spain and Australia, as well as emerging countries like Brazil, China, India, South Korea and Mexico, joined the Committee. In general, the weight of these countries in determining the recommendations remained lower than that of the founding countries.

Secondly, the Committee sought to become more transparent. Since its inception, the Committee had acted not only with discretion, but also in relative secrecy.[36] So much so that *the details of the agreement which formalized its creation in 1975, took no less than five years before being unveiled! In the last two decades, however, the Committee unveiled not only the content of its decisions, but also the technical research and surveys that supported them. Furthermore, although the Committee meetings have remained closed to the public, it adopted the practice of sending reports to the public outlining the proceedings of the meetings. It also adopted the practice of submitting drafts of the recommendations for comments prior to formal issue. Nonetheless, it seems to me that the topic of the supposed democratic deficit was certainly not entirely overcome.*

8 CONCLUSION

Perhaps the most common mistake when analyzing the environment of banking regulation and its periodic crises is to ignore the incentives that the regulation provides to financial innovation. And the problem of financial innovation — just like any innovation — is that it acts as a biological mutation: it is intelligible ex post facto*, but unpredictable* ex ante facto.

Regulatory limitations on the activities of financial intermediaries provide, in effect, a double incentive to financial innovation: they stimulate innovation both by the industry directly regulated and the development of new instruments, markets and financial players who are willing to offer substitute services. New regulations are the very seed of new crises. Although the capitalist system can be immensely dynamic and productive, it is not inherently stable.

It turns out that, even if one accepts that the banking industry needs an up-regulation, it is not clear which regulatory parameters will be adopted. One thing is the decision to regulate; quite another, is to decide how to do it. The banking activity is currently very diverse, and it is not been clear which will be the regulatory schemes that could maximize stability and minimize losses in credit circulation and allocation of risk between financial players.

Moreover, the banking industry is globalized, and there is a dynamic regulatory competition (how large is this regulatory competition is a moot point). Hence, if a country greatly increases its regulation, it runs the risk that the industry migrates to other countries. Therefore, banking regulation tends to be based on minimum parameters, which cannot be sufficiently effective.

An additional point is that in the aftermath of the crisis, there will be no imminent risk of a new credit bubble; this will only happen again when confidence is restored. At first, however, increased regulation may serve both to restore confidence and to increase the uncertainty in financial markets. That is why it seems to me that neither the exact characteristics of banking regulation, nor the time when the reforms will be put into practice are not predictable so far.

All this means, in short, that the experience of recent decades suggests parsimony in the attempts of financial institutional engineering and restraint in relation to the expectations of what can be achieved with such reforms.

On the other hand, the topic of the reforms has an important component of political pressure and public opinion. Financial activity is now markedly international, while its regulation is, prima facie, distinctly national. The national regulation, however, is increasingly intertwined *with the processes of international regulation and, internationally, the Basel Committee has played a prominent role, but as the Basel Committee is a bureaucratic entity, we wonder whether in the aftermath of the crisis the control of reforms will be sent back to the hands of politicians. Time will tell.*

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NOTES

1 *Faria, José Eduardo. Poucas certezas e muitas dúvidas: o direito depois da crise financeira.* Revista DIREITO GV. *São Paulo: DIREITO GV, v. 5, n. 2, jul-dez 2009, pp.297-324.*

2 *In the United States, in the period between the publication of the Glass-Steagall Act and the early 1970s, commercial banks could not really compete. To mitigate risks, the regulation limited both the compensation that banks could pay depositors (through the so-called Regulation Q) and the amount they could charge borrowers (usury prohibitions). During this period, all commercial banks offered essentially the same services and competed primarily on service quality.*

Bank officials spent much of their time trying to attract customers, taking them to lunches, handing out gifts, playing golf with them, etc.. Today, with deregulation, the scenario has completely changed and commercial banks compete primarily on price and products.

3 *The Gramm-Leach-Bliley Act, GLBA, 1999, in practice, ended with the separation between commercial banking and investment banking. This instrument has allowed commercial banks and investment banks to consolidate into a single entity. In addition, the GLBA turned the FED into a regulator of financial holding companies, which is fundamentally a new designation for organizations with complex financial services. The divide between commercial bank and investment bank was once buried with the approval by the FED, in September 2008, of the conversion of Morgan Stanley and Goldman Sachs into bank holding companies.*

4 *On this topic, see Charles W. Calomiris (Financial Innovation, Regulation and Reform, Cato Journal, v. 29, n. 1, p. 65-92, 2009). Note that government incentives for high-risk loans reached such an apex that in 2006, a law was passed to encourage rating companies to relax their risk rating criteria for subprime securitizations.*

5 *Fannie Mae is the nickname of FNMA (Federal National Mortgage Association). Set up in 1938, it is the largest branch of the United States. Freddie Mac is the nickname of the FHLMC (Federal Home Loan Mortgage Corporation), which has existed since 1970 and is only slightly smaller than Fannie Mae.*

6 *After the crisis, both companies broke and were nationalized.*

7 *On this topic, see Koch, T.W.; Macdonald, S. Scott (*Bank Management. *The Dryden Press, Harcourt College Publishers. 4. ed., 2000).*

8 *Proposed by Keynes, the Havana Charter was the charter of the International Trade Organization, ITO. Its core purpose was to establish an international financial institution called the International Clearing Union, ICU, and an international currency called bancor. Having been signed by 53 countries in 1948, the Havana Charter was vetoed by the U.S. Congress and never came into force.*

9 *A key exception was the Eurocurrency Standing Committee, established in 1962 in response to concerns about the growth of the Eurodollar markets.*

10 *The Group of Ten, G10, actually includes 11 countries, namely Belgium, Canada, France, Italy, Japan, Holland, England, United States, Germany, Sweden and Switzerland.*

11 *Although it is the most important one, the Basel Committee is not only dedicated to coordinating international financial regulation. Another important entity is the International Organization of Securities Commission (popularly known only as IOSCO) which, just like the former, was established in the 1970s. In this article, however, I focus on the role of the Basel Committee.*

12 *The Bank of International Settlements, BIS is an international organization that promotes monetary and financial cooperation and serves as a "bank of central banks".*

13 *The best example is the adoption of the minimum capital regime based on risk-weighted assets (see Resolution CMN 2099/94 and subsequent amendments). Another good example is the creation of internal control systems at banks, which largely mirrored the guidelines of the Framework for Internal Control Systems in Banking Organisations, published by the Basel Committee in early September 1998 (see Resolution CMN 2554/98 and subsequent amendments).*

14 *In June 1974, several banks delivered Dutch marks to Herstatt against the promise of receiving dollars that should be deposited in New York. Before that dollars could be deposited (due to the time difference), the Herstatt was settled in Germany, reviving old controversies about the lack of cooperation among regulators internationally.*

15 *Basel committee: Report on the supervision of banks' foreign establishments - Concordat, set. 1975. Available at: <http://www.bis.org/publ/bcbs00a.htm>.*

16 *The Banco Ambrosiano went bankrupt after lending US$ 1.4 billion to its subsidiary in Luxembourg. This gave rise to a dispute between Italy and Luxembourg on which country is responsible for overseeing and providing liquidity to save the bank from bankruptcy.*

17 *Basel Committee: Principles for the supervision of banks' foreign establishments (Concordat), mai. 1983. Available at: <http://www.bis.org/publ/bcbsc312.htm>.*

18 *Thus, in cases where regulation of the host country was considered improper, the authorities of the home country should regulate more strictly or even discourage or prevent the financial institution from operating in the country concerned.*

19 *Originally founded in Karachi, Pakistan, the BCCI had been among the top ten largest banks in terms of asset value. Nevertheless, the bank was involved in a massive scheme to launder money from drug trafficking, terrorist financing, weapons and nuclear technology, among other crimes. Its bankruptcy was described as one of the largest financial scandals in history. The BCCI had taken advantage of a huge gap in the amendment of the Concordat of 1983, which failed to establish a clear rule for supervising bank holdings, thus allowing the BCCI - a holding company based in Luxembourg — to create a complex multinational corporate structure to escape the banking supervision.*

20 *Core Principles for Effective Banking Supervision, Oct. 2006. Available at: <http://www.bis.org/publ/bcbs129.htm >.*

21 *Consolidated KYC Risk Management, Oct. 2004. Available at: <http://www.bis.org/publ/bcbs110.htm >.*

22 *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version, Jun. 2006. Available at: <http://www.bis.org/publ/bcbs128.htm>.*

23 *V. Home-Host Information Sharing for Effective Basel II Implementation, Available at: <http://www.bis.org/publ/bcbs125.htm>, and High-level Principles for the Cross-Border Implementation of the New Accord, Available at: <http://www.bis.org/publ/bcbs100.htm >.*

24 *The Concordat of 1975 established five principles:*

(a) foreign banks should be jointly supervised by the monetary authorities of the host country and home country;

(b) no banking establishment could escape banking supervision, as required by the host country and the home country; (C) supervising the liquidity of banks should be the primary responsibility of the host country, as foreign institutions generally follow local practices for liquidity management and follow local rules and procedures applicable to their operations; (d) supervising the solvency of branches would be the primary responsibility of the home country, and supervising the solvency of subsidiaries would be the responsibility of the host country; (e) the regulatory authorities of the host country and home country should cooperate and exchange information.

25 *1 - Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*

26 *2 - Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible. 3 - Licensing criteria: The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained. 4 - Transfer of significant ownership: The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties. 5 - Major acquisitions: The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.*

27 *6 - Capital adequacy: Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement. 7 - Risk management process: Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution. 8 - Credit risk: Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios. 9 - Problem assets, provisions and reserves: Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves. 10 - Large exposure limits: Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties. 11 - Exposures to related parties: In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes. 12 - Country and transfer risks: Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks. 13 - Market risks: Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted. 14 - Liquidity risk: Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems. 15 - Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.*

28 *16 - Interest rate risk in the banking book: Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk. 17 - Internal control and audit: Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations. 18 - Abuse of financial services: Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial* *sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities. 19 - Supervisory approach: An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system. 20 - Supervisory techniques: An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.*

29 *21 - Supervisory reporting: Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.*

30 *22 - Accounting and disclosure: Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.*

31 *23 - Corrective and remedial powers of supervisors: Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation. 24 - Consolidated supervision: An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide. 25 - Home-host relationships: Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.*

32 *In the original document: "Supervisors must be satisfied that…".*

33 *Basle Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, item 51, p. 16. Available at: < http://www.bis.org/publ/bcbs04a.pdf >. ("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.")*

34 *Basle Committee on Banking Supervision, The New Basel Capital Accord, Part 1, item A.1, p. 1. Available at: < http://www.bis.org/publ/bcbsca03.pdf >. ("The New Basel Capital Accord [the New Accord] will be applied on a consolidated basis to internationally active banks.")*

35 *It must be noted that this idiosyncratic aspect of international regulation is not exclusive to the banking sphere. A parallel phenomenon can be found, for example, in the areas of aviation, antitrust and telecommunications, with varying degrees of membership of developing countries, including Brazil.*

36 *To illustrate, see the declaration given by Huib J. Muller, former president of the Basel Committee, in 1988: "We don't like publicity. We prefer, I might say, our hidden secret world of the supervisory continent". Apud David Zaring (Informal Procedure, Hard and Soft, in International Administration, 5 Chi.* J. Int'l L. *n. 547, p. 555-556, 2005.*

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