Introductory Note to the Basle Supervisors' Committee's Paper on Off-Balance Sheet Exposures

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Introductory Note

In 1983, I.L.M. published the so-called revised "Basic Concordat" with an introductory note by Frederick R. Dahl of the U.S. Federal Reserve System [22 I.L.M. 900 (1983)]. That comment explained the origin and purposes of the Committee on Banking Regulations and Supervisory Practices, a committee of representatives from the banking supervisors of twelve industrial countries set up in 1975 under the auspices of the Bank for International Settlements (BIS). The Committee is often referred to in the literature as the "Cooke Committee" after Peter Cooke, former Governor of the Bank of England who chaired the Committee for a significant period of time or simply as the Basle Supervisors' Committee. The Committee meets in Basle generally once a month and, as stressed by Frederick Dahl, works to improve coordination and cooperation among banking supervisors in the countries concerned "in the interest of a healthy international banking system."

In the last few years a focus of concern for industrial country banking supervisors has been bank capital adequacy, particularly capital adequacy for the major multinational banks that are the medium for the international payments system underlying world trade, investment and financial transactions. The near failure of Continental Illinois, a major U.S. bank heavily involved in the system, and the specter of what that failure would have meant to the world economy increased supervisory concern for the soundness of this group of banks, most of whom hold large portfolios of third world and Eastern European debt against which it would be prudent to make additional provision. Indeed, the International Lending Supervision Act of 1983, the U.S. Congress' response to the debt crisis,/1 in §908 required the United States' central bank, the Board of Governors of the Federal Reserve System,/2 to work toward encouraging governments, central banks and foreign bank regulatory agencies to maintain and, where appropriate, strengthen the capital base of all banking institutions involved in international lending./3 In the case of United States banks, this emphasis on additional capital for banks involved in international lending apparently worked: since 1983 the nine money center U.S. banks decreased their Latin American exposure as a percent

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of capital from 163% to 124% while capital exposures to all developing countries for these banks declined from 209% to 148% and for 15 other large banks from 153% to 104%.\textsuperscript{4}

Unfortunately, these figures are somewhat deceptive. They measure international lending by U.S. banks to developing countries as a percentage of capital; they say nothing about capital adequacy of banks for other types of business. Since the International Lending Supervision Act was passed at the end of 1983, the nature of international banks' participation in the international financial markets has changed radically. For a number of years the Monetary and Economic Department of the BIS has published a quarterly study of and statistics on International Banking Developments; in the October 1985 issue the format was changed to include a survey of lending through the international capital markets, i.e., securities issuance and the role played by the international banks in such issuance. The BIS announced that thereafter every six months not only international banking developments would be surveyed, but also financial market developments, for the simple reason that "... the steady decline in the share of syndicated bank credit in total new lending, which began after the 1982 debt crisis, showed no sign of abating [...] and "... the volume of new lending through the capital market had increased very substantially,..."\textsuperscript{5} The trend has not stopped; the May issue of the BIS publication reports that the second half of 1985 was characterized by "continued strong growth of total market activity, with a further expansion of security issues and a new decline in the volume of syndicated bank credits."\textsuperscript{6} This shift in the nature of the international banks' activities in the international financial markets, as the October BIS study remarked, presents both the institutions and the supervisory authorities "... with the problem of adequately assessing, and providing for, the risks involved in the new financing techniques that have been developed over recent years, a task in which past experience offers little guidance."\textsuperscript{7}

To aid in the concerned central banks' understanding of the new techniques, the Basle group of central bank governors of the Group of Ten established in early 1985 a study group to examine the innovations in the conduct of international banking. That study, under the title of "Recent Innovations in International Banking" was published by the BIS in April 1986/8. It consists of extensive description of the new financial instruments such as note issuance facilities (NIFs), currency and interest rate swaps, options, and forward rate agreements, and attempts to assess the issues raised for the global economy and its functioning by these innovations. At the same time this larger study was undertaken, the Basle Supervisors' Committee undertook a study of the innovations' implications for the safety and soundness of the banks under their tutelage, in particular the fact that much of the new business is not reflected in the balance sheets of the banks
participating in the innovations. To the extent that
capital adequacy has been assessed as a ratio of balance
sheet items (e.g., loans) to capital, the reason for
supervisory concern is obvious. The study printed here is
the Basle Supervisors' Committee's common thoughts on how
prudential standards for the new world of international
banking might be implemented. It is a most interesting
example of coordination in international banking supervision
and it remains to be seen how the separate country banking
supervisors respond in their oversight. The U.S.
authorities have already acted; all three U.S. commercial
banking supervisors have published this spring proposed risk
based capital requirements/9 that as of this writing are
going through the process of receipt of commentary by the
industry and other interested persons and reconsideration
before final issuance.

FOOTNOTES

1. See Lichtenstein, The U.S. Response to the International
Debt Crisis: The International Lending Supervision Act

2. The Board, along with the U.S. supervisor for national
banks the Comptroller of the Currency, participates in
the meetings of the central banks of the major
industrialized countries (the so-called Group of Ten
Countries although with Switzerland the group consists
of eleven countries) also usually held at the Bank for
International Settlements in Basle and in the meetings
of that group's Supervisors' Committee, described above.

3. See Statement by William Taylor, Director, Division of
Banking Supervision and Regulation, Board of Governors
of the Federal Reserve System before the Subcommittee on
International Finance and Monetary Policy of the
Committee on Banking, Housing and Urban Affairs, U.S.
Senate, June 25, 1986 at pp. 3-4.

4. See Statement of Robert R. Bench, Deputy Comptroller of
the Currency Before the Subcommittee on International
Finance and Monetary Policy of the Committee on Banking,
Housing, and Urban Affairs, U.S. Senate, June 25, 1986
at p. 5.

5. BIS, International Banking and Financial Market
Developments, October 1985, p. 22.

6. BIS, International Banking and Financial Market
Developments, May 1986, p. 11.

7. BIS, International Banking and Financial Market
Developments, October 1985, p. 23.