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**Core Principles for Effective Banking
Supervision: New Concepts and
Challenges**

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**Core Principles for Effective Banking Supervision:
New Concepts and Challenges***

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Abstract

This paper examines certain fundamental issues raised by the existence and application of the newly revised *Core Principles for Effective Banking Supervision*. First, what expectations are imposed upon jurisdictions that adopt the *Core Principles*? Second, are the *Core Principles* an effective response to the international financial crisis? Third, what is the legal status of the *Core Principles*—mere guidelines, a significant new source of law in international practice, or something in between? The paper argues that the *Core Principles* represents a distinctive and highly effective approach to the coordination of legal norms across borders that, in the context of international banking practice, may operate as a set of functionally binding norms – and possibly a new source of law in international practice.

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Introduction

The Bank for International Settlements (BIS), located in Basel, Switzerland, is a *multilateral* bank for *national* central banks.¹ Traditionally, it has been supported by the Group of Ten large industrialized democracies, consisting of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, United Kingdom, and the United States, with Luxembourg and Switzerland as additional participants. The BIS assists these central banks in the transfer and investment of monetary reserves, and it often plays a role in settling international loan arrangements. Of increasing significance since the mid-1970s, however, is its role as a forum for international cooperation and policy development in bank regulation and supervision, under the auspices of its Committee on Banking Regulations and Supervisory Practices, now the Basel Committee on Bank Supervision ('the Basel Committee').² It is a standing committee of the BIS, originally intended not to *mandate* harmonization among its members' supervisory approaches, but to *promote* cooperation among them. Most of its work has been to produce broad principles to assist national supervisors in establishing their own detailed cooperative arrangements.

The Basel Committee has its origins in the dramatic failure of Herstatt Bank in Germany and Franklin National Bank in New York in 1974,³ with spill-over effects throughout the increasingly permeable national banking markets.⁴ The unsteady cooperation of national supervisors in responding to this crisis led the Group of Ten to sponsor an informal understanding on resolution of international bank failures, now known as the Basel Concordat (1974). Acknowledging the need to establish a framework for multilateral bank supervision, the BIS formed a committee consisting of foreign exchange and supervisory officials from the Group of Ten, plus several other countries with significant involvement in or impact on international financial services.⁵

Since its founding, the Basel Committee has gone from being a somewhat ad hoc group that 'promoted discussion and development of common solutions

¹See <http://www.bis.org/bcbs/index.htm?ql=1> (providing information about BIS and activities of Basel Committee on Banking Supervision) (accessed Jan. 16, 2013). For a history of the BIS, see LeBor (2013).

²The Basel Committee has increased the size of its membership several times. With Spain joining on 1 February 2001, the Committee consisted of thirteen participant states: the G-10 countries plus Luxembourg, Spain and Switzerland. In March 2009 the Basel Committee extended membership to Australia, Brazil, China, India, Mexico, Russia, and South Korea. See Daniel Pruzin, *Basel Committee Announces Expansion of Membership to Emerging Economies*, BNA INT'L BUS. & FIN. DAILY (June 11, 2009), available at <http://pubs.bna.com/> (discussing implications of expanded membership) (accessed June 12, 2009). In June 2009, Argentina, Indonesia, Saudi Arabia, South Africa, and Turkey joined the committee. The Basel Committee has also invited Hong Kong and Singapore to take part in the committee's deliberations.

³See Hall (2001) at 68 (discussing Herstatt crisis).

⁴See Malloy (2012) (arguing that current international financial crisis constitutes crisis among permeable, but still fundamentally national economies).

⁵Zaring (1998) at 287.

to cross-border financial issues, with domestic implementation of ‘soft law’ international agreements,¹ to something increasingly programmatic in its work. That work has evolved into something progressively oriented towards rule-generation rather than the elucidation of general non-binding ‘principles.’ Indeed, this evolution may be characterized as a gradual movement from general principles to ‘standards’ and *core* principles.

From ‘General Principles’ to ‘Best Practices’

In the traditional terms of public international law,² the 1974 Concordat was not a source of law, but rather a set of three broad principles—what is commonly referred to as ‘soft law.’³ First, all international banks should be subject to supervision. Second, this supervision should be adequate, based on standards that both home-country and host-country authorities might apply. Third, supervision of a joint venture involving parent banking institutions based in different home countries should be the primary responsibility of the host-country authority of the joint venture. The practical application of these principles would obviously require cooperation between home-country and host-country authorities. For example, supervising liquidity of financial institutions (*i.e.*, the ability to meet obligations as they came due) generally would be the responsibility of host-country authorities. Supervising solvency (*i.e.*, the condition in which assets exceed net liabilities) generally would be the responsibility of host-country authorities for foreign subsidiaries and joint ventures, and of home-country authorities for a banking institution operating trans-border through foreign branches.

Unfortunately, the utility of this ‘general principles’ approach proved to be limited. The 1974 Concordat did little to ease the financial crisis that was precipitated by the 1982 failure of Banco Ambrosiano, an Italian-based bank

¹Arner & Buckley (2010) at 198.

²*See, e.g.*, Article 38 of the Statute of the International Court of Justice, which sets forth sources of international law, which may be consulted when determining whether an international norm exists:

- (a) international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;
- (b) international custom, as evidence of a general practice accepted as law;
- (c) the general principles of law recognized by civilized nations;
- (d) . . . judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law.

Statute of the International Court of Justice, art. 38(1), June 26, 1945, 59 Stat. 1055, 1060, T.S. No. 993.

³*See, e.g.*, Lee (1998) at 7-8 (‘Unlike a hard law which places obligations on members, a soft law places no legally binding duties on the signatories. The [Basel capital adequacy accords] as a soft law could, nevertheless, merge multi-jurisdiction compliance procedures for those banks operating in cross-border transactions’). *See also* Zaring (1998) 303-04 (noting views of one commentator that Basel Committee’s work has ‘some sort of legal effect’ and can therefore be characterized as ‘international soft law’).

with a Luxembourg subsidiary.¹ The home-country authority, Italy, initially took the position that it would honor only the bank's domestic obligations. However, a significant group of creditors of the Luxembourg subsidiary did eventually reach a settlement with the Bank of Italy covering obligations in excess of \$300 million. In light of this experience, the Concordat was revised in 1983² to provide a larger measure of detail concerning home- and host-country supervisory responsibilities. The 1983 Concordat refers to itself as a 'report' that has the modest objective of setting out 'certain principles which the Committee believes should govern the supervision of banks' foreign establishments by parent and host authorities.'³ The identified principles 'are not necessarily embodied in the laws of the countries represented on the Committee. Rather they are recommended guidelines of best practices in this area, which all members have undertaken to work towards implementing, according to the means available to them.'⁴ Despite this tentative tone, the Concordat points to 'the . . . acceptance by the [BIS] Governors of the principle that banking supervisory authorities cannot be fully satisfied about the soundness of individual banks unless they can examine the totality of each bank's business worldwide through the technique of consolidation. . . .'⁵ Hence, in its early practice, the Basel Committee was moving from hortatory language of general principles to the memorialization of an undertaking to work towards implementation of best practices, and this is done against the background expectation that supervision requires transparent, consolidated access.⁶

The principles themselves are basic and thematic. The first principle is that effective cooperation between home-country and host-country authorities is essential to the supervision of international banking operations. The next two principles follow from the first: no banking establishment should escape supervision, and that supervision must be adequate. Hence, home-country and host-country authorities must keep each other effectively informed of serious problems that arise in or affect a parent bank's foreign operations. The Concordat identified three categories of operation in international banking; branches, subsidiaries, and joint ventures or consortia. As to each of these categories, the Concordat recommends certain allocations of primary authority for the resolution of liquidity and solvency problems. Essentially, these principles attempt to establish relative roles that home-country and host-country authorities should undertake.⁷ (See Figure 1, *infra*, for Concordat

¹See Alford (2005) 246 (discussing collapse of Banco Ambrosiano).

²Bank for International Settlements, Committee on Banking Regulations and Supervisory Practices, Principles for the Supervision of Banks' Foreign Establishments (1983), reprinted in Malloy (2013) at 87B92 (1983 Concordat).

³1983 Concordat at 87.

⁴1983 Concordat at 88.

⁵1983 Concordat at 87.

⁶See, e.g., 1983 Concordat at 88: 'Adequate supervision of banks' foreign establishments calls not only for an appropriate allocation of responsibilities between parent and host supervisory authorities but also for contact and co-operation between them.'

⁷In addition, as to the supervision of a bank's foreign exchange operations, the Concordat takes

categories.)

Figure 1. *Supervision under the Concordat (1983)*

Type of Establishment	Type of Problem	
	Solvency	Liquidity
Branch	primarily matter for home country authority	primarily matter for host country authority
Subsidiary	joint responsibility of host and country authorities	primary responsibility for host country authority
Joint venture	primary responsibility with country of incorporation	primary responsibility with country of incorporation

From Best Practices to Expectations and Standards

Since the issuance of the 1974 Concordat and its 1983 revision, the Basel Committee has given further attention to the problems of supervising trans-border banking enterprises. An April 1990 Supplement to the Concordat sought to strengthen the principle of effective information flow between home-country and host-country authorities.¹ The Supplement makes the principles concerning information transfer more explicit and detailed. Part D of the 1990 Supplement deals with the problem of domestic bank secrecy laws² that might otherwise impede information flows necessary for effective transnational regulation and supervision of banking.³

The theme of coordination and cooperation in trans-border bank supervision intensified in the wake of the 1991 collapse of the Bank of Credit

the position that these should be the joint responsibility of the home-country and host-country authorities. 1983 Concordat at 92. Home-country authorities are expected to monitor the internal controls of their international banking enterprises. Host-country authorities are expected to monitor the foreign exchange exposure of foreign bank operations within their territories.

¹Bank for International Settlements, Committee on Banking Regulation and Supervisory Practices, *Supplement to the Basel Concordat Ensuring of Adequate Information Flows between Banking Supervisory Authorities* (1990), reprinted in Malloy (2013) at 93-96 (1990 Supplement). In June 2006, The Basel Committee on Banking Supervision issued a revised paper setting out general principles for the sharing of information between home country and host country banking supervisors within the context of the new Basel II capital accord. Daniel Pruzin, *Basel Committee Releases Revised Paper on Info Sharing Between Home, Host Officials*, BNA Banking Daily (June 5, 2006), available at <http://pubs.bna.com/ip/bna/bbd.nsf/eh/A0B2W2U7A7> (accessed Jan. 17, 2013). The Basel Committee paper, *Home-Host Information Sharing for Effective Basel II Implementation*, is available on the Bank for International Settlements Web site at <http://www.bis.org/publ/bcbs125.htm> (accessed Jan. 17, 2013).

²For discussion of foreign bank secrecy laws, see Malloy (2011b) at 463-468.

³1990 Supplement, *supra*, at 95-96.

and Commerce International (BCCI).¹ The Basel Committee took the significant step in June 1992 of issuing a report establishing binding minimum standards on the supervision of international banking enterprises.² While the standards are not, on their own terms, directly binding on states, BIS participating states are *expected* to implement them, and other states are encouraged to do so.³ Thus, with the issuance of the Minimum Standards, we see a shift from the declaration of best practices to the establishment of expectations of implementation. Moreover, even if the standards may not be on their own terms affirmative obligations of participating states, it appears that the expectation of compliance has created a defensive legal principal that *permits* one participating state to discriminate against financial services firms from states that in fact do not meet the minimum standards.

There is a discernible movement from the Concordat's hortatory language of 'recommended guidelines for best practice'⁴ to the obligatory language in the Minimum Standards that speaks of 'principles [that] have been reformulated as minimum standards . . . which G-10 supervisory authorities expect each other to observe.'⁵ How, then, would these obligations be enforced? The structure of the standards themselves suggests an answer to this question. The first three minimum standards enunciate what may appear—despite the 'standards' terminology—to be typical 'soft law' principles:

1. All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision. . . .
2. The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank's and, if different, banking group's home-country supervisory authority. . . .
3. Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the

¹On the BCCI scandal, see Bhala (1994).

²Bank for International Settlements, Basel Committee on Banking Regulation and Supervisory Practices, *Report on Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishment* (1992), reprinted in Malloy (2013) at 96-100 ('Minimum Standards').

³Minimum Standards, *supra*, at 96. In the United States, statutory provisions anticipating implementation of the Minimum Standards were enacted as part of the Federal Deposit Insurance Corporation Improvements Act, Pub. L. No. 102-242, Dec. 19, 1991, 105 Stat. 2236 (1991) (codified at scattered sections of 12 U.S.C.). *See, e.g.*, 12 U.S.C. §§ 3105(d)-(2)(1)(A) (approval of U.S. branch of foreign bank; comprehensive supervision of applicant on consolidated basis by home state authorities required); 3105(d)(3)(A) (same; consent of home state to establishment of U.S. branch as standard of approval by U.S. authorities); 3105(e)(1)(A) (termination of U.S. office of foreign bank when foreign bank not subject to comprehensive supervision on consolidated basis by home state authorities), *as amended*, DFA, § 173(a)-(b), 124 Stat. at 1440 (codified at 12 U.S.C. § 3105(d)(3), (e)(1)).

⁴Minimum Standards, *supra*, at 96.

⁵Minimum Standards, *supra*, at 96.

banks or banking groups for which they are the home-country supervisor.¹

However, the fourth minimum standard establishes that failure of a participating state to maintain comprehensive and consolidated supervision over its financial services firms constitutes a basis for denial of entry into a participating state's banking market.² The standard states as follows:

4. If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.³

At this point, 'soft law' may begin to harden. The substantive impact of this defensive standard is reinforced by the General Agreement on Trade in Services ('GATS').⁴ The GATS establishes 'a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization,'⁵ by applying GATT nondiscrimination principles to trade in services.⁶ The GATS itself specifically applies to financial services.⁷ The requirements of nondiscriminatory treatment do not, however, prevent WTO member states from enforcing domestic regulations for 'prudential reasons, including for the protection of . . . depositors . . . or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system.'⁸ Though this has yet to be the subject of a WTO dispute, it is reasonable to argue that the fourth minimum standard embodies one clear 'prudential reason' for a WTO member to discriminate against a financial services firm of another member state.

¹Minimum Standards, *supra*, at 97-99.

²For an administrative decision of the U.S. Federal Reserve System determining that a foreign bank was subject to 'comprehensive and consolidated supervision' in its home country in approving a federal branch for the foreign bank, see *ICICI Bank Limited, Mumbai, India, Order Approving Establishment of a Branch* (Oct. 19, 2007), available at <http://www.federalreserve.gov/newsevents/press/orders/orders20071019a1.pdf> (accessed Jan. 17, 2013).

³Minimum Standards, *supra*, at 99.

⁴General Agreement on Trade in Services, 15 April 1994, Agreement Establishing the World Trade Organization, Annex 1B, 33 Int'l Leg. Materials 1167 (1994) ('GATS'). WTO members are not permitted to derogate from adherence to Annex 1B. Agreement Establishing the World Trade Organization, art. XVI, & 5. For an excellent review of the GATS and its implications for banking, see Case (1996).

⁵GATS, preamble.

⁶See, e.g., GATS, art. II, & 1 (applying most-favored-nation treatment to services and service suppliers); GATS, art. XVII, & 1 (applying national treatment to services and service suppliers of other WTO member states).

⁷GATS, Annex on Financial Services.

⁸GATS, Annex on Financial Services, ' 2(a).

Notice and Comment in International Practice

That the rules generated by the Basel Committee are not simply ‘soft law’ in the traditional sense is suggested by the consistent practice surrounding what is perhaps the most significant recent development in terms of substantive international supervision of banking—the formulation of uniform rules governing the measurement and enforcement of capital adequacy of banks.¹ In U.S. practice, capital adequacy requirements predate the efforts of the Basel Committee.² However, the rules developed under the auspices of the committee are aimed not only at a capital adequacy regime that is effective as a purely regulatory matter but also at one that will encourage a multilateral convergence of regulatory standards. Each successive refinement of the capital adequacy regime has involved notice and consultation not only national regulators but also with affected firms. This ‘notice and comment’ practice³ would seem largely superfluous for ‘soft law’ principles with no binding effect.

In any event, the capital adequacy rules set forth ‘the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the Committee intend to implement in their respective countries.’⁴ They quickly became the global standard for capital adequacy requirements in the vast majority of states,⁵ well beyond those participating directly in the Basel Committee.

The BIS Committee continued to refine the details and mechanics of risk management and supervision.⁶ However, attempts at revision have become

¹Bank for International Settlements, Final Report for International Convergence of Capital Measurement and Capital Standards, *reprinted in* 4 Fed. Banking L. Rep. (CCH) ¶47-105 (Mar. 15, 1996) [hereinafter Final Report]. For analysis and discussion of the BIS capital adequacy rules and their implementation in U.S. law, see Malloy (2011a), vol. 2, at § 7.03[C][4][b]. On the current capital adequacy rules applied by the U.S. regulators, see Office of the Comptroller of the Currency, et al., *Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies*, 77 Fed. Reg. 75259 (2012) (jointly reporting to Congressional committees on differences among capital and accounting standards used by federal agencies). based and leverage capital adequacy guidelines for BHCs); 70 Fed. Reg. 61,068 (2005).

²See Malloy (1988) at 75-76, 81-87 (discussing pre-BIS U.S. regulatory practice).

³*Cf.* 5 U.S.C. § 553(b)-(d) (establishing public notice and comment procedures for promulgation of substantive rules of U.S. administrative agencies).

⁴Final Report at 51,166.

⁵Daniel Pruzin, *Basel Committee Announces Deal On Key Remaining Accord Issues*, BNA Banking Daily, May 12, 2004, available at <http://www.bna.com> (accessed Jan. 17, 2013).

⁶See, e.g., BIS, Committee on Banking Supervision, *The Treatment of the Credit Risk Associated with Certain Off-Balance-Sheet Items* (July 1994); BIS, Committee on Banking Supervision, *Risk Management Guidelines for Derivatives* (July 1994); BIS, Committee on Banking Supervision, *Amendment to the Capital Accord of July 1988* (July 1994); BIS, Committee on Banking Supervision, *Prudential Supervision of Banks' Derivatives Activities* (December 1994); BIS, Committee on Banking Supervision, *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance-Sheet Items* (April 1995); BIS, Committee on Banking Supervision, *An Internal Model-Based Approach to Market Risk Capital Requirements* (April 1995); BIS, Committee on Banking Supervision, *Public Disclosure of the Trading and*

increasingly contentious,¹ and this situation has been exacerbated by the international financial crisis precipitated in 2008.² By contrast, the committee's experience with its other major project of the 1990s has been considerably more encouraging.

Core Principles

The Original Version

In the late 1990s, the Basel Committee, in conjunction with the International Monetary Fund and the International Bank for Reconstruction and Development, developed a set of *Core Principles for Effective Bank Supervision*.³ The *Core Principles* consisted of twenty-five basic principles, ranging from preconditions for effective supervision⁴ to principles for cross-border banking,⁵ together with commentary provided by the Committee. The original principles were, of course, not binding, but they did provide a basic

Derivatives Activities of Banks and Securities Firms (Nov. 1995); BIS, Committee on Banking Supervision, *Supervisory Framework for the Use of 'Backtesting' in Conjunction with the Internal Models Approach to Market Risk Capital Requirements* (Jan. 1996); BIS, Committee on Banking Supervision, *Amendment to the Basle Capital Accord to Incorporate Market Risks* (Jan. 1996); BIS, Committee on Banking Supervision, *Interpretation of the Capital Accord for the Multilateral Netting of Forward Value Foreign Exchange Transactions* (April 1996).

¹See Malloy (2006) (questioning the current effect and implications of capital adequacy regime).

²On the causes and effects of the 2008 crisis, see Malloy (2010).

³Basel Committee on Banking Supervision, *Basel Core Principles for Effective Banking Supervision* (Sept. 22, 1997), reprinted in 37 Int'l Leg. Mat. 405 (1998) ('Core Principles 1997').

⁴Core Principles 1997, Principle 1:

1. An effective system banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations 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.

⁵Core Principles 1997, Principles 23-25:

23. Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

reference point for supervisors worldwide, and undoubtedly reflected a persuasive view of what expectations required for ‘prudential reasons’ under the GATS.¹

The 2006 Revision

The Committee issued a revised version of the *Core Principles* in October 2006.² The basic focus remained the same,³ but a new ‘umbrella principle’ advised banks to establish integrated risk management systems across the range of different risks that banks faced.⁴ In advance of the 2008 crisis, the Core Principles had already begun to focus more specifically on risk management. Criteria for evaluating liquidity,⁵ operational,⁶ and interest rate risks⁷ were also enhanced, and the need for internal controls to prevent the use of bank facilities for international criminal activity (such as money laundering, terrorist financing, and fraud) was strengthened.⁸ Bank supervisors from central banks

¹*Cf., e.g.*, Core Principles 1997, Commentary on Principle 25:

As the host country supervisory agency supervises only a limited part of the overall operations of the foreign bank, the supervisory agency should determine that the home country supervisor practices consolidated supervision of both the domestic and overseas operations of the bank

²Basel Committee on Banking Supervision, *Basel Core Principles for Effective Banking Supervision* (October 2006), available at <http://www.bis.org/publ/bcbs130.htm> (accessed Jan. 18, 2013).

³A paper comparing the 1999 and 2006 versions of the Core Principles methodology is available at <http://www.bis.org/publ/bcpmastermapping.pdf> (accessed Jan 17. 2013).

⁴Core Principles 2006, Principle 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.

⁵Core Principles 2006, Principle 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.

⁶Core Principles 2006, Principle 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.

⁷Core Principles 2006, Principle 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.

⁸Core Principles 2006, Principle 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

and supervisory agencies in 120 countries endorsed the updated version of the *Core Principles*. This did nothing to forestall the 2008 financial crisis, which was already well in train by the time the revision was issued in final form in October 2006.

The 2012 Revision

The response to that crisis appears to be the enhancement and more fine-tuned criteria for supervision and risk analysis. In December 2011, the BIS Committee proposed revisions to the *Core Principles*¹ to increase the number of core principles from 25 to 29 and to establish 36 new ‘assessment criteria’—31 ‘essential’ criteria and 5 ‘additional’ criteria—to give detailed articulation to the application of the principles. This was in addition to the upgrading of 33 other criteria from the existing 2006 assessment methodology to ‘essential’ criteria establishing minimum requirements for all countries. Comments on the proposed revisions were due March 20, 2012,² and in September 2012, the Basel Committee published the final version of a newly revised *Core Principles*.³

With its amplified criteria, the new version creates a more detailed, more analytical framework for effective supervision that is only suggested by a comparison of the principles included in each version. (See Figure 2, *infra*, for an analytical comparison of the three versions.) The new version is intended to ensure, after the 2008 financial crisis,⁴ the effective supervision of banks under individual national jurisdictions. In a display of consensus largely absent in other post-crisis initiatives, as of mid-September 2012 the revised *Core Principles* had been endorsed by global banking supervisors and central bankers from more than 100 countries.⁵

The revised *Core Principles* strengthen the requirements for supervisors, the approaches to supervision, and supervisors’ expectations for banks. Enhancement of supervision is to be reached through a greater focus on risk-based supervision, early intervention, and timely supervisory actions. The

high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

¹Basel Committee on Banking Supervision, *Consultative Document: Core Principles for Effective Banking Supervision* (Dec. 2011), available at <http://www.bis.org/publ/bcbs213.pdf> (accessed Jan. 17, 2013). See Daniel Pruzin, *Basel Committee Proposal Revises Core Principles on Banking Supervision*, BNA Int’l Bus. & Fin. Daily (Dec. 21, 2011), available at <http://www.bna.com> (reporting on proposed revisions) (accessed Jan. 17, 2013).

²*Consultative Document, supra*, at 1.

³Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Sept. 2012), available at <http://www.bis.org/publ/bcbs230.htm> (‘Core Principles 2012’) (accessed Jan. 18, 2013). See Daniel Pruzin, *Basel Committee Issues Final Version Of Revised Core Principles on Supervision*, BNA INT’L BUS. & FIN. DAILY (Sept. 17, 2012), available at <http://www.bna.com> (discussing significance of revised Core Principles) (accessed Jan. 17, 2013).


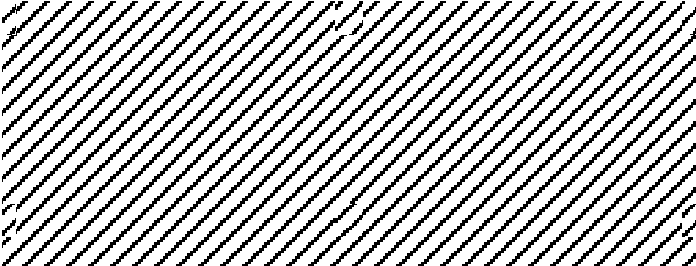
⁴For discussion of the 2008 crisis, see Malloy (2011a) vol. 2, at § 6.02[E]. See generally Malloy (2010) (providing analysis and explanation of subprime mortgage market collapse leading to broader crisis).

⁵Pruzin, *Basel Committee Issues Final Version, supra*.

revised set of twenty-nine principles was reorganized to reflect a more logical structure, highlighting the difference between what *supervisors* do and what they expect *banks* to do.

Figure 2. Comparative Analysis of Successive Versions of Core Principles

Current 2012 Version	2006 Version	Original 1997 Version
1. Responsibilities, objectives and powers	1. Objectives, independence, powers, transparency and cooperation	Principle 1
2. Independence, accountability, resourcing and legal protection for supervisors	[Redacted]	
3. Cooperation and collaboration		Principle 23
4. Permissible activities	2. Permissible activities	Principle 2
5. Licensing criteria	3. Licensing criteria	Principle 3
6. Transfer of significant ownership	4. Transfer of significant ownership	Principle 4
7. Major acquisitions	5. Major acquisitions	Principle 5
8. Supervisory approach	19. Supervisory approach	Principle 16
9. Supervisory techniques and tools	20. Supervisory techniques	Principle 17
10. Supervisory reporting	21. Supervisory reporting	Principle 18
11. Corrective and sanctioning powers of supervisors	23. Corrective and remedial powers of supervisors	Principle 22
12. Consolidated supervision	24. Consolidated supervision	Principles 20
13. Home-host relationships	25. Home-host relationships	Principles 24, 25
14. Corporate governance	[Redacted]	
15. Risk management process	7. Risk management process	
16. Capital adequacy	6. Capital adequacy	Principle 6
17. Credit risk	8. Credit risk	Principle 7
18. Problem assets, provisions and reserve	9. Problem assets, provisions and reserves	Principle 8
19. Concentration risk and large exposure limits	10. Large exposure limits	Principle 9
20. Transactions with related parties	11. Exposures to related parties	Principle 10
21. Country and transfer risks	12. Country and transfer risks	Principle 11
22. Market risk	13. Market risks	Principle 12
23. Interest rate risk in the banking book	16. Interest rate risk in the banking book	Principle 13
24. Liquidity risk	14. Liquidity risk	Principle 13
25. Operational risk	15. Operational risk	Principle 13

26. Internal control and audit	17. Internal control and audit	Principle 14
27. Financial reporting and external audit		Principle 19
28. Disclosure and transparency	22. Accounting and disclosure	Principle 21
29. Abuse of financial services	18. Abuse of financial services	Principle 15
		APPENDIX I: Special Issues Related to Government-Owned Banks APPENDIX II: Deposit Protection

Principles 1 through 13¹ address supervisory powers, responsibilities and functions, emphasizing effective risk-based supervision, and the need for early intervention and timely supervisory actions. Principles 14 to 29² address supervisory expectations of banks, focusing on the importance of effective corporate governance and risk management, as well as compliance with supervisory standards. The four new principles in the revised *Core Principles* cover (i) cooperation and coordination between home and host supervisors with respect to crisis management and resolution for cross-border banks;³ (ii) effective corporate governance as an essential element in safe and sound banking;⁴ (iii) maintenance and assessment of contingency funding and recovery arrangements to deal with future crisis;⁵ and, (iv) supervision of disclosure and transparency.⁶ However, on the assumption that national supervisors would naturally establish higher expectations for systemically important banks (SIBs) subject to their jurisdiction, the Committee decided *not* to include a separate new principle applicable to SIBs.⁷

Conclusion

International banking regulation and supervision continues to be formulated in a domestic context, with certain limited exceptions. Important examples of regional arrangements for the regulation of financial services are

¹Core Principles 2012, *supra*, at 10-11.

²*Id.* at 11-13.

³Core Principles 2012, *supra*, at 11, Principle 13.

⁴Core Principles 2012, *supra*, at 11, Principle 14.

⁵Core Principles 2012, *supra*, at 11, Principle 15.

⁶Core Principles 2012, *supra*, at 13, Principle 28.

⁷Core Principles 2012, *supra*, at 5. *See also* Pruzin, *Basel Committee Issues Final Version, supra* (discussing issue of SIB coverage).

provided by the European Union¹ and the North American Free Trade Agreement (NAFTA).² At the international level, the most notable exceptions to the domestic orientation of banking regulation involve the work of the BIS and the General Agreement on Trade in Services (GATS). These involve supervisory initiatives arising out of multilateral undertakings and responding to the need for regulation of international activities on an international basis.³ For the most part, however, the increasing interdependence of international banks and their activities has caused domestic regulators to fashion *multilateral* undertakings to secure what are still essentially *domestic* objectives.⁴

Looking at the *Core Principles* in this supervisory environment, it is evident that they impose on the many states that have endorsed this regime an enhanced responsibility to create a consolidated approach to bank supervision and regulation, with greater cooperation and transparency with supervisors in other jurisdictions and rigorous attention to risk analysis and assessment. It is possible that the impact of the *Core Principles* will be broader than this group of states, however, because of the interplay of the reasonable expectations that they create concerning prudential supervision vis-à-vis the substantive legal obligations of the GATS.

A more speculative question concerns the likely effectiveness of the *Core Principles* as a response to the international financial crisis. It is evident that neither the original version nor the 2006 version had any appreciable effect on the roots of that crisis. In light of that experience, however, the 2012 version seems to be more purposeful in directing national supervisors to the need for ongoing, consolidated, and proactive risk assessment and management than was the case in past iterations. If there is a vulnerability here, it lies in the juncture between articulated international principles and implementation at the national level. Enforcement of these prudential standards remains a matter of individual state action.

What, then, is the legal status of the *Core Principles*—mere guidelines, a significant new source of law in international practice, or something in between? Clearly, the *Core Principles*—like the other initiatives of the Basel Committee—are not sources of international law in the traditional sense. This may suggest, however, that we need to look at the *Core Principles*, and the processes that create, implement and enforce them, on their own terms. In application, they appear to represent a distinctive and highly effective approach to the coordination of legal norms across borders that, in the context of international banking practice, may operate as a set of functionally binding norms—and possibly a newly emergent source of law in international practice.

¹See, e.g., *Reorganisation and Winding up of Credit Institutions*, Directive 2001/24/EC (Apr. 4, 2001) (providing for EU supervision and resolution of failing banks). For a comparative analysis including EU financial services regulation, see Trachtman (1995). See also Malloy (2013) at 23-25, 102-110 (discussing effect of EU regulation of banking).

²For discussion of the impact of NAFTA on banking regulation, see Malloy (2013) at 39-50.

³See Malloy (2011b) at 402 (discussing international regulation).

⁴See, e.g., Malloy (2011a), vol. 3, at § 15.02[C][1] (discussing background of BIS capital adequacy rules). On multilateral efforts to foster convergence in bank regulatory standards, see Volkman (1998).

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