

# RECENT DEVELOPMENTS

## THE DAIWA WAKE-UP CALL: THE NEED FOR INTERNATIONAL STANDARDS FOR BANKING SUPERVISION

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### I. INTRODUCTION

At the close of the business day on February 2, 1996, Japan's tenth largest bank, the Osaka-based Daiwa Bank of Japan, ended its banking operations in the United States, returned all federal and state banking licenses to the appropriate banking regulatory authorities and announced the sale of its U.S. operations to the world's second largest bank, the Sumitomo Bank of Japan.<sup>1</sup> These actions came as a result of the November 2, 1995 revocation of the bank's U.S. charter by the Federal Reserve Board and joint orders by the Federal Reserve Board, the New York State Banking Department, and the bank regulators of five other states, terminating the U.S. operations of the Daiwa Bank and ordering the bank to cease all operations within 90 days.<sup>2</sup> The November 2nd action by the Federal Reserve Board marked the first time the Federal Reserve Board has exercised its power to expel a foreign bank from the U.S. market.<sup>3</sup>

The unprecedented action by the U.S. banking regulatory authorities follows an eleven-year cover-up by Toshihide Iguchi, a bond trader at the

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<sup>1</sup> *Daiwa Bank Returns Its U.S. Banking Licenses; Completes Sale to Sumitomo*, PR Newswire, Feb. 2, 1996, available in LEXIS, News Library, Curnws File.

<sup>2</sup> *Regulators Order Shut-down of U.S. Daiwa Units in 90 Days*, BNA BANKING DAILY, Nov. 3, 1995. The five state regulators which joined in issuing terminating orders are: California, Illinois, Massachusetts, Florida & Georgia. *Id.*

<sup>3</sup> John R. Wilke, *Stern Rebuke: In a Signal to Japan, U.S. Bars Daiwa Bank and Indicts Institution*, WALL ST. J., Nov. 3, 1995, at A1.

New York branch, of over \$1 billion in trading losses.<sup>4</sup> While some experts speculate that Iguchi could not have been acting alone due to the amount and length of the cover-up, it is generally accepted that senior management did not know of the losses until Iguchi sent a letter on July 17, 1995 to the bank president admitting and explaining the losses.<sup>5</sup> On July 21, Iguchi followed up his letter of admission with a letter of recommendations as to how to continue the cover-up. Eleven days after learning of the losses, Daiwa management decided that because of the current banking crisis in Japan, it would be best for both Daiwa and the Japanese banking industry if the losses were not disclosed until November.<sup>6</sup> In pursuit of this plan, the New York branch, on July 31, submitted a falsified balance sheet to the Federal Reserve.<sup>7</sup>

While the Daiwa cover-up is troublesome in that both American and Japanese regulatory authorities were unable to detect the problems,<sup>8</sup> the aspect with the most serious implications for international banking is the action taken by the Japanese Ministry of Finance. The Japanese regulatory authority, the Ministry of Finance, was informed of the losses of the Daiwa New York branch on August 8, 1995.<sup>9</sup> Rather than promptly informing the Federal Reserve Board as is expected under international banking community

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<sup>4</sup> *Delay seen in sentencing of Daiwa Bank's Iguchi*, Japan Economic Newswire, Sept. 11, 1996, available in LEXIS, News Library, Curmws File. Iguchi has pled guilty to six charges of fraud and forging documents. He faces a maximum penalty of 90 years imprisonment and a \$3 million fine.

<sup>5</sup> Wilke, *supra* note 3.

<sup>6</sup> On April 4, 1996, the former director of the New York branch pleaded guilty to a charge of conspiring to defraud regulatory authorities and admitted that he had been concerned that "disclosure would have resulted in Daiwa's stock going down and also likely would have negatively affected the Japanese stock market and other Japanese banks." Patricia Hurtado, *Ex-Daiwa Bank Boss Admits Fraud*, NEWSDAY, Apr. 5, 1996, at A41. See also *The Japanese Financial System: Hearing of the House Banking and Financial Institutions Committee*, Oct. 16, 1995.

<sup>7</sup> Wilke, *supra* note 3.

<sup>8</sup> *Foreign Branches of Japanese Banks Will Face Tougher Audits, Agency Says*, BNA INTERNATIONAL BUSINESS AND FINANCE DAILY, Nov. 2, 1995. The Ministry of Finance, which had been criticized previously for failing to detect losses, is now implementing changes in its supervisory practices. Japanese banks will now be required to report to the Ministry more often on overseas operations. Additionally, the Ministry will require outside auditors to conduct more frequent audits of overseas branches. The Ministry will penalize banks whose reports differ from those of independent auditors.

<sup>9</sup> Wilke, *supra* note 3.

standards,<sup>10</sup> the Ministry of Finance did not inform the U.S. authorities of the losses until September 18, forty-one days after the Ministry of Finance learned of the losses.<sup>11</sup> While some consider this to have been a serious breach of trust on the part of the Japanese government,<sup>12</sup> U.S. officials have stressed that they do not believe that there is a systematic risk with all Japanese institutions<sup>13</sup> and that the delay was the result of different perceptions of what was expected under international standards.<sup>14</sup>

The delay in communication resulted from the Japanese regulatory practice of involving an initial investigation to determine the validity of claims so as to prevent unnecessary public panic and negative perceptions of the banking industry.<sup>15</sup> Ministry of Finance officials stressed that the Iguchi letter of admission, which was given to the Ministry, was not enough to trigger the obligation to report to the Federal Reserve Board until the claims were substantiated.<sup>16</sup> The Ministry of Finance also stressed that the need for urgent notification to the American authorities was lessened because U.S. depositors were not in any danger and the only ones who would suffer

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<sup>10</sup> Kohei Murayama, *U.S. upset over Japan's late reporting of Daiwa problem*, Kyodo News, Oct. 10, 1995, available in WESTLAW, Japanecon database.

<sup>11</sup> Wilke, *supra* note 3. As a result of failing to notify American regulatory authorities upon learning of the losses, Daiwa Bank Ltd. pleaded guilty to 16 felonies: 10 counts of falsifying books and records, 2 counts of conspiracy, 2 counts of wire fraud, 1 count of a cover-up and 1 count of obstructing an examination by the Federal Reserve Board. Peter Truell, *Daiwa Bank Admits Guilt in Cover-Up*, N.Y. TIMES, Feb. 29, 1996, at D1. The \$340 million fine was the fourth-largest fine ever levied by the United States against a financial institution. David E. Kalish, *Daiwa Bank is Hit With \$340M Fine*, REC., Feb. 29, 1996, at B1.

<sup>12</sup> "If this episode is characteristic of the attitude of Japanese regulators towards compliance with U.S. laws, I seriously question whether there can be any basis for trusting and relying on the Finance Ministry or the Bank of Japan." *Hearing on the Daiwa Bank of Japan and Foreign Banks Operating in the U.S. Before the Senate Banking Committee*, Nov. 27, 1995 [hereinafter *Hearings*] (statement of Senator Alfonse M. D'Amato).

<sup>13</sup> Murayama, *supra* note 10.

<sup>14</sup> *Handling of Daiwa Raises Questions About Japan's Supervisory Approach*, BNA INTERNATIONAL BUSINESS AND FINANCE DAILY, Oct. 16, 1995. The banking environment in Japan is quite different in terms of its regulatory framework. The system is based on mutual trust between the Ministry of Finance, the Bank of Japan and the commercial banks. The Japanese banks are only given licenses after strict inspections at which point it is then expected that the bank will perform on the basis of good faith and trustworthiness.

<sup>15</sup> Murayama, *supra* note 10.

<sup>16</sup> *Id.*

monetary losses were the Japanese bank shareholders.<sup>17</sup> The Daiwa incident highlights the proposition that while a country can enact legislation to address the special problems inherent in foreign bank supervision, the most effective step towards adequate supervision would be the development of international standards for bank supervision.

## II. INTERNATIONAL BANKING REGULATIONS AND SUPERVISION

Twenty years ago, banks chartered in a specific country would rarely expand their operations into other countries. However, over the past two decades, international banking practices have increased dramatically.<sup>18</sup> Despite the importance of international banking, the increased intertwining of capital markets has increased the risk that problems abroad are more likely to have serious effects on the domestic market.<sup>19</sup> When one country begins to experience difficulties in the banking sector, the integrity of the worldwide financial system is weakened.

Despite the growth in international banking, there is no supranational regulation of international banking.<sup>20</sup> The reason for this is the banking industry's ability to effectuate a government's monetary policies. Therefore, the international banking community is regulated by the various national supervisory authorities in accordance with the national law of the host-state. Even though there is no supranational regulation, certain nations have voluntarily agreed to adhere to a series of principles and guidelines

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<sup>17</sup> *N.Y. regulator urges Japan banks to remember Daiwa case*, Kyodo Newswire, Feb. 3, 1996, available in WESTLAW Japanecon. database. For fiscal year 1995, which ended March 31, Daiwa suffered a net loss of 171.75 billion yen or 113.76 yen per share. *Scandal-tainted Daiwa Bank Posts Big Losses in FY '95*, Japan Economic Newswire, May 24, 1996, available in LEXIS, News Library, Curnws File. As a result of the scandal, Daiwa is currently undergoing a dramatic restructuring plan involving a reduction of overseas operations. *Daiwa Bank unveils 2-year reconstruction plan*, Japan Economic Newswire, Apr. 1, 1996, available in LEXIS, News Library, Curnws File. See also, *Daiwa Bank Set to Withdraw from Malaysia*, Jiji Press Ticker Service, July 10, 1996, available in LEXIS, News Library, Curnws File; *Scotiabank Announces Purchase of Daiwa Bank Canada*, Aug. 14, 1996, available in LEXIS, News Library, Curnws File.

<sup>18</sup> Daniel B. Gail et al., *The Foreign Bank Supervision Enhancement Act of 1991: Expanding the Umbrella of "Supervisory Reregulation"*, 26 INT'L LAW. 993, 994 (1992).

<sup>19</sup> Daniel M. Laifer, *Putting the Super Back in the Supervision of International Banking*, Post-BCCI, 60 FORDHAM L. REV. 467, 467 (1992).

<sup>20</sup> The General Agreement on Trade in Services deals with the competitive conditions aspect of market access.

established by the Committee on Banking Regulations and Supervisory Practices (Basel Committee).<sup>21</sup> These guidelines are centered around the principle that the multinationalization of banking practices mandates the need for standards in order to ensure the continued growth and stability of the international banking community. Despite the fact that these principles are not legally binding, they have been quite influential in shaping the supervisory practices of the member countries.

#### A. *The General Agreement On Trade in Services*

On April 15, 1994 in Marrakech, Morocco, the Uruguay Round of Multilateral Trade Negotiations came to a conclusion and the General Agreement on Trade in Services (GATS) became the first legally enforceable agreement covering trade in services.<sup>22</sup> The General Agreement on Trade in Services resulted from the recognition of the "growing importance of trade in services for the growth and development of the world economy."<sup>23</sup> Accordingly, the objective of GATS is to "establish 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."<sup>24</sup> To facilitate this progressive liberalization, the GATS carries forward the core General Agreement on Tariffs and Trade (GATT) principles of most-favored nation status<sup>25</sup> and national treatment.<sup>26</sup> Additionally, as

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<sup>21</sup> Laifer, *supra* note 19, at 469. The members of the Committee are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. *Id.*

<sup>22</sup> General Agreement on Trade in Services, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, LEGAL INSTRUMENTS-RESULTS OF THE URUGUAY ROUND vol. 33; 33 I.L.M. 1167 (1994) [hereinafter GATS]. The GATS is one of the annexes to the Agreement Establishing the World Trade Organization. Accordingly, any country signing the WTO Agreement is bound to accept the GATS.

*See generally*, Mary E. Footer, *The International Regulation of Trade in Services Following Completion of the Uruguay Round*, 29 INT'L LAW. 453, 454 (1995) (describing previous attempts of the GATT Contracting Parties to address sectoral issues in the services field).

<sup>23</sup> GATS, *supra* note 22, at prmb1.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* art II:1. "With respect to any measure covered by this agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than it accords to like services and service suppliers from any other country."

with the GATT, GATS provides a framework for addressing barriers to trade in services, includes specific commitments by WTO members to restrict the use of barriers and provides a forum for negotiations.

The General Agreement on Trade in Services was made specifically applicable to the financial services sector by the inclusion of the Annex on Financial Services which adapted the general provisions of GATS to the financial sector.<sup>27</sup> The Annex provides that Members may retain domestic regulations for "prudential reasons, including for the protection of investors, depositors, policy holders 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."<sup>28</sup> However, these regulations must meet the Article VI requirement of being "administered in a reasonable, objective and impartial manner."<sup>29</sup> Additionally, while GATS allows Members to maintain qualification and licensing requirements, the requirements must be "based on objective and transparent criteria"<sup>30</sup> and should "not [be] more burdensome than necessary to ensure the quality of service."<sup>31</sup>

While the GATS carries forward the core GATT principles of most-favored nation status and national treatment, these principles as applied to financial services were limited by the Second Annex on Financial Services which allowed countries a temporary right to withdraw or modify the commitments made during negotiations without offering compensation.<sup>32</sup> Another departure from the most-favored-nation principle provided by the

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<sup>26</sup> *Id.* art XVII:1 ". . . each Member shall accord to services and services suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than it accords to its own like services and service suppliers."

<sup>27</sup> *Id.* Annex on Financial Services.

<sup>28</sup> *Id.* Annex on Financial Services § 2(a).

<sup>29</sup> *Id.* art VI:1.

<sup>30</sup> *Id.* art IV:4(a).

<sup>31</sup> *Id.* art IV:4(b).

<sup>32</sup> *Id.* Second Annex on Financial Services.

This temporary right was granted so as to enable the parties to continue negotiations on market liberalization because at the conclusion of the Uruguay Round, the United States was unsatisfied with other countries' commitments. The United States was not willing to lock in its own liberal policies without reciprocal guarantees of full market access on a most-favored nation basis. Joel P. Trachtman, *Trade in Financial Services Under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 COLUM. J. TRANSNAT'L L. 37, 54 (1995). The U.S. maintained that if other countries did not liberalize their markets, the U.S. would seek a MFN exemption for those countries. *U.S. Expects Talks on Liberalizing Trade in Financial Services to End on Schedule*, BNA INT'L TRADE DAILY, Dec. 13, 1994.

Annex is that a "Member may recognize prudential measures of any other country in determining how the Member's measures relating to financial services shall be applied."<sup>33</sup> The Member can recognize the prudential measures of another country either as a basis of an agreement or of its own accord.<sup>34</sup> However, the most-favored nation principle resurfaces because Members to such an agreement are bound to allow others the opportunity either to negotiate accession or to negotiate a comparable agreement.<sup>35</sup> Furthermore, if the Member recognizes the prudential measures of the other country of its own accord, the Member must allow other countries the opportunity to demonstrate that comparable circumstances exist.<sup>36</sup> Overall, the fact that financial services have been brought under the auspices of GATS is likely to result in increased market access because of the commitment to "enter into successive rounds of negotiations . . . with a view to achieving a progressively higher level of liberalization."<sup>37</sup>

### *B. Basel Committee Principles for International Bank Supervision*

The Basel Committee, whose members consist of the supervisory authorities of twelve nations, was organized in 1975 when the failure of the German Herstatt Bank made it apparent that failures in the banking industry abroad could have serious effects on domestic banking.<sup>38</sup> The Committee was formed to provide a forum for "regular co-operation between its member countries on banking supervisory matters."<sup>39</sup> The goal of the Committee is to achieve harmonization of member nations' banking laws indirectly by the issuance of principles and guidelines.

The trend towards the globalization of the banking community prompted the Committee to set as its first goal the development of guidelines on the respective roles of the home and host country supervisors in ensuring that the entire banking operation was adequately supervised.<sup>40</sup> The result was the issuance of the Basel Concordat of 1975 which set forth five basic principles.

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<sup>33</sup> *Id.* Annex on Financial Services § 3(a).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* Annex on Financial Services § 3(b).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* art XIX:1.

<sup>38</sup> Duncan E. Alford, *Basel Committee Minimum Standards: International Regulatory Response to the Failure of BCCI*, 26 GW J. INT'L L. & ECON. 241, 247 (1992).

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

These principles stressed that all foreign banks should be supervised and that this responsibility should be shared by both the parent-country and host-country supervisory authorities. The Concordat recommended that the host authority should take primary responsibility for the adequacy of the foreign establishment's liquidity<sup>41</sup> and that the parent authority should be primarily responsible for the solvency of the foreign establishment.<sup>42</sup> The fifth principle of the Basel Concordat was that, because of the need for cooperation between supervisory authorities, legal restraints on the transfer of information should be removed.<sup>43</sup>

As the international banking community continued to grow, Committee members realized that while the 1975 Concordat was an important step forward in international bank supervision, there was a need to develop specific supervisory standards for national regulatory authorities.<sup>44</sup> The result of this realization was the Revised Concordat of 1983 which built on the primary objective of ensuring that no foreign banking establishment would escape adequate supervision by introducing the approaches of "consolidated supervision" and "dual key" supervision.<sup>45</sup>

Consolidated supervision expanded the parent regulatory authority responsibilities by advocating that the parent regulator monitor the parent bank's total risk exposure and capital adequacy by reviewing the total operations of the parent bank.<sup>46</sup> Dual key supervision involves the regulatory authorities of each nation concurrently assessing each other's ability to supervise and carry out its responsibilities.<sup>47</sup> The Revised Concordat advocates that the host country either deny entry approval to an institution from a country which does not adequately supervise its institutions

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<sup>41</sup> The rationale behind holding the host authorities primarily responsible for liquidity supervision is that foreign establishments generally have to conform to local practices for liquidity management and must comply with local liquidity regulations. *Id.* at 248.

<sup>42</sup> *Id.* The rationale behind holding the parent authorities primarily responsible for the supervision of the solvency of overseas establishments is that the parent authorities are more familiar with the entire operations of the bank.

<sup>43</sup> See generally W. Peter Cooke, *Supervising Multinational Banking Organizations: Evolving Techniques for Cooperation Among Supervisory Authorities*, 3 J. COMP. CORP. L. & SEC. REG. 244, 246 (1981) (summarizing Basel Concordat).

<sup>44</sup> Alford, *supra* note 38, at 250.

<sup>45</sup> Committee on Banking Regulation and Supervisory Practices, *Revised Basel Concordat on Principles for the Supervision of Banks' Foreign Establishments*, reprinted in 22 I.L.M. 901 (1983) [hereinafter Revised Concordat].

<sup>46</sup> *Id.* at 904.

<sup>47</sup> Alford, *supra* note 38, at 252.

or "impose specific conditions governing the conduct of the business of such establishments."<sup>48</sup> Parent bank regulatory authorities are urged either to discourage the parent bank from expanding operations into the proposed host country or to attempt to expand their jurisdictional reach if it is believed that the host country does not adequately supervise banking operations.<sup>49</sup> The rationale behind the dual key approach was to prevent a "race to the bottom" approach in banking regulation by which countries lowered supervisory practices in order to attract foreign investment and foreign capital.<sup>50</sup>

In 1990, the Basel Committee issued the Supplement to the Basel Concordat on Ensuring of Adequate Information Flows between Banking Supervisory Authorities (Supplement) which reiterated the need for adequate cooperation and communication among regulatory authorities in order to improve the quality of supervision of cross-border banking.<sup>51</sup> The Supplement stressed that because "[m]utual trust between supervisory authorities can only be achieved if exchanges of information can flow with confidence in both directions,"<sup>52</sup> supervisory authorities should undertake an affirmative commitment to cooperate with each other on all prudential matters.<sup>53</sup>

While the Revised Concordat and the 1990 Supplement improved the standards that were initially set forth in the Basel Concordat of 1975, there were still important gaps in the allocation of supervisory responsibilities. These gaps were exploited by the Bank of International Credit and Commerce (BCCI). BCCI was able to evade supervision by setting up a holding company in Luxembourg. This entity held two parent banks: BCCI S.A., incorporated in Luxembourg, and BCCI Overseas, incorporated in the Cayman Islands. Each of these banks had subsidiaries in foreign countries. This structure gave BCCI the ability to evade consolidated supervision. Since there were two parent banks, there were two countries responsible for the overall safety of the institution and neither of the parent banks conducted its primary operations in the country of incorporation. This problem was

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<sup>48</sup> Revised Concordat, *supra* note 45, at 903.

<sup>49</sup> *Id.*

<sup>50</sup> Alford, *supra* note 38, at 253.

<sup>51</sup> Basel Committee on Banking Regulation and Supervisory Practices: Supplement to the Basel Concordat on the Ensuring of Adequate Information Flows between Banking Supervisory Authorities (Apr. 1990) available in LEXIS, INTLAW Library, BDIEL File [hereinafter 1990 Supplement].

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

compounded by the fact that both Luxembourg and the Cayman Islands had bank secrecy laws.<sup>54</sup>

The BCCI scandal led to the Basel Committee 1993 Report on Minimum Standards for the Supervision of International Banking Groups and Their Cross-border Establishment. The Report continued to build on the principles of consolidated supervision, dual key supervision, and communication between supervisory authorities, while setting forth guidelines for the implementation of these principles.<sup>55</sup> In reiterating the need for consolidated supervision, the Report recommends that the host country supervisors should ensure that the parent country receives consolidated financial statements of the global operations of the bank and that the parent authority has the means to satisfy itself as to the completeness and validity of the statements.<sup>56</sup> Additionally, the host country should assure itself that the parent country has the authority to prevent banks in its jurisdiction from establishing organizational structures that circumvent supervision.

The second minimum standard that the Report advocates is that the host country should determine whether the parent supervisory authorities have consented to the establishment of the foreign branch. Additionally, the host country should assess whether the organizational structure of the operation is likely to cause confusion as to the appropriate allocation of supervisory responsibilities.<sup>57</sup> If the organizational structure has this potential, the host country is advised to make sure that the other countries are aware of their expected responsibilities and are willing to perform them.

The third minimum standard is that both the host country and parent country should assure themselves of their right to gather information concerning foreign operations. Finally, the Report recommends that if any of the other minimum standards are not met, the host country should decide that if no other restrictive practices are available to help assure itself of the

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<sup>54</sup> Hal S. Scott, *Supervision of International Banking Post-BCCI*, 8 GA. ST. U. L. REV. 487, 493 (1992). Generally, bank secrecy laws protect the banker-client privilege by imposing criminal sanctions for the release of information about a client's activities. C. Todd Jones, *Compulsion Over Comity: The United States' Assault on Foreign Bank Secrecy*, 12 J. INT'L L. & BUS. 454, 461 (1992).

<sup>55</sup> Basel Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* (June 1992) available in LEXIS, INTLAW Library, BDIEL File [hereinafter *Minimum Standards*].

<sup>56</sup> *Id.*

<sup>57</sup> This type of situation is most likely to occur when the bank incorporates in a country other than the one in which most of the operations are located.

safety of the bank on a "stand-alone" basis, it should deny entry approval. The Committee recommends that in judging whether the parent authority meets the minimum standards, the host country should be the one to consider whether the parent authority is trying to meet those standards.<sup>58</sup>

### III. THE NEED FOR INTERNATIONAL SUPERVISORY STANDARDS

#### A. *Supervisory Measures in the United States*

In the United States, foreign banking establishments are regulated in accordance with the Foreign Bank Supervision and Enhancement Act,<sup>59</sup> which was enacted as Title II of the Federal Deposit Insurance Corporation Improvement Act of 1991.<sup>60</sup> While some critics of the U.S. regulation argue that it serves to protect domestic banks from foreign competition,<sup>61</sup> the United States financial market has been open and foreign banks have become increasingly important for the United States.<sup>62</sup> International banks in the United States add approximately \$20 million annually to the U.S. economy.<sup>63</sup> Foreign banks occupy over 48 million feet of office space and employ over 300,000 American workers.<sup>64</sup> Foreign banks hold approximately one-third of all commercial and industrial loans and serve as an important source of export financing.<sup>65</sup> The importance of international banking to the U.S. economy demonstrates that while it is necessary to ensure the stability of the banking industry as a whole, it is also in the best interests of the U.S. market

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<sup>58</sup> *Id.*

<sup>59</sup> Foreign Bank Supervision Enhancement Act of 1991, Pub. L. No. 102-242, secs. 201-215, 105 Stat. 2286, 2286-305 (codified at 12 U.S.C. § 3101-3111) (1989) [hereinafter FBSEA].

<sup>60</sup> L. Todd Gibson, *Note, The Foreign Bank Supervision Enhancement Act of 1991: Short Run Consequences En Route to the Long Term Goal*, 27 CASE W. RES. J. INT'L L. 119, 126 (1995).

<sup>61</sup> See generally, Raj Bhala, *Tragedy, Irony, and Protectionism After BCCI: A Three Act Play Starring Maharajah Bank*, 48 SMU L. REV. 11 (1994).

<sup>62</sup> *Hearing on Closing of Japan's Daiwa Bank U.S. Operations Before House Banking and Financial Services Committee*, Dec. 5, 1995 [hereinafter Dec. 5 Hearings]. Currently, there are 252 foreign banks operating in the United States.

<sup>63</sup> Prepared statement by Lawrence R. Uhlick, Before House Banking and Financial Services Subcommittee; Subcommittee on Financial Institutions and Consumer Credit, Dec. 5, 1995, available in LEXIS.

<sup>64</sup> *Id.*

<sup>65</sup> Dec. 5 Hearings, *supra* note 62.

to remain open to foreign banks.

The United States was the first member of the Basel Committee to enact legislation which codified the principles of the Report on Minimum Standards.<sup>66</sup> The Foreign Bank Supervision Enhancement Act marked a departure from the practice of having individual state authorities serve as the primary regulators of foreign banks to a system in which the Federal Reserve serves as the primary regulator, regardless of whether the foreign establishment receives a state or federal charter.<sup>67</sup> While this position of the Federal Reserve Board implements the proposed guidelines of the Revised Concordat and Report on Minimum Standards, it could possibly violate the national treatment principle of GATS. This is due to the dual supervisory structure of the U.S. regulatory system which permits U.S. banks to receive a charter from either a state regulator or the Federal Reserve Board.

Under the Foreign Bank Supervision Enhancement Act, the Federal Reserve Board is given the sole authority to authorize the entry of a foreign bank into the U.S. market.<sup>68</sup> The threshold determination that the Federal Reserve Board makes in deciding whether to grant entry approval involves a two-step analysis. The Board first determines whether the "bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country."<sup>69</sup> Secondly, the Board determines whether the "foreign bank has furnished to the Board the information it needs to adequately assess the application."<sup>70</sup>

In assessing whether the foreign bank is subject to consolidated supervision, the Board evaluates the foreign country's banking laws and its ability to carry those laws out by determining whether that regulator "receives sufficient information on the worldwide operations of the foreign bank . . . to assess its overall financial condition and compliance with law."<sup>71</sup> In deciding whether the foreign regulator receives this information, there are four main factors the Federal Reserve Board takes into consideration. These factors are whether the home-country regulator: (a) ensures that the parent bank monitors global activities; (b) receives information on the condition of branches outside of its jurisdictional reach; (c) receives consolidated

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<sup>66</sup> Gibson, *supra* note 60, at 120.

<sup>67</sup> Alford, *supra* note 38, at 243.

<sup>68</sup> 12 U.S.C. § 3105(d)(1) (1989).

<sup>69</sup> 12 U.S.C. § 3105(d)(2)(A) (1989).

<sup>70</sup> 12 U.S.C. § 3105(d)(2)(B) (1989).

<sup>71</sup> 12 C.F.R. s 211.24(c)(ii) (1993).

financial statements; and (d) evaluates prudential standards on a world-wide basis.<sup>72</sup>

In addition to the two mandatory standards that a foreign bank must meet in order to be granted entry approval, there are four discretionary standards that the Board can take into consideration. These discretionary standards are: (a) whether the parent authorities have consented to the proposed establishment in the U.S.;<sup>73</sup> (b) whether the bank is currently complying with U.S. law;<sup>74</sup> (c) whether the parent bank has adequately assured the Board as to its intention to continue to provide information on global operations;<sup>75</sup> and (d) whether management practices and history of the bank indicate that the bank has the capacity to safely engage in international banking.<sup>76</sup>

Besides giving the Federal Reserve Board the sole authority to approve entry into the United States, the Foreign Bank Supervision Enhancement Act granted the Federal Reserve Board the power to expel a foreign bank from operating in the U.S. market.<sup>77</sup> The Board can terminate the operations of a foreign bank if it is found that (1) the bank is not subject to consolidated supervision,<sup>78</sup> or (2) reasonable cause exists to believe that the bank has engaged in unsafe or illegal banking practices and that it is against the public interest for the continued operation of the foreign bank.<sup>79</sup>

#### *B. The United States Withdrawal from the GATS Financial Services Agreement*

Despite the openness of the U.S. financial market,<sup>80</sup> on June 29, 1995, the United States withdrew its offer of full market liberalization<sup>81</sup> and decided to limit future access to institutions from countries which provide reciprocal

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<sup>72</sup> *Id.*

<sup>73</sup> 12 U.S.C. § 3105(d)(3)(A) (1989).

<sup>74</sup> 12 U.S.C. § 3105(d)(3)(D) (1989).

<sup>75</sup> 12 U.S.C. § 3105(d)(3)(C) (1989).

<sup>76</sup> 12 U.S.C. § 3105(d)(3)(B) (1989).

<sup>77</sup> 12 U.S.C. § 3105(e)(1) (1989).

<sup>78</sup> 12 U.S.C. § 3105(e)(1)(A) (1989).

<sup>79</sup> 12 U.S.C. § 3105(e)(1)(B) (1989).

<sup>80</sup> See *supra* notes 62-65 and accompanying text.

<sup>81</sup> *U.S. Withdraws Offer in WTO Talks; Shocked Partners Dub It a Bombshell*, BNA INT'L TRADE DAILY, June 20, 1995.

rights.<sup>82</sup> Assistant Secretary of the Treasury Jeffrey Schafer stated that the withdrawal was occasioned by the failure of other countries to offer full market access on a most-favored nation basis so that there "were import, significant deficiencies across the sector."<sup>83</sup> The insufficiency of other countries' offers was determined to pose a risk to U.S. financial institutions which could be forced to withdraw from the foreign market without a U.S. right to seek redress under the World Trade Organization system.<sup>84</sup> Additionally, the United States decided global market liberalization could be more readily achieved in bilateral negotiations because full access to the U.S. market would deprive the United States of negotiating leverage and cement other countries' restrictions on entry.<sup>85</sup>

### C. *The WTO As a Forum for Binding Standard Development*

The United States' withdrawal from the financial services agreement is not only a set-back for the globalization of the financial services sector, it is also a potential set-back for the development of international standards for banking supervision. The WTO provides a forum for the development of binding supervisory standards.<sup>86</sup> The GATS provides that "[w]herever

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<sup>82</sup> Bob Davis & John R. Wilke, *Trade Official Is 'Close' to Limited Pact To Liberalize Global Financial Services*, WALL ST. J., July 25, 1995. Additionally, the United States promised to maintain existing levels of access and national treatment for institutions already operating in the U.S. market. Frances Williams, *EU Eager to Salvage Financial Services Pact*, FIN. TIMES, July 1, 1995, at A1.

Despite the withdrawal by the United States, on July 28, 1995, forty-three nations entered into an agreement on the liberalization of financial services markets. Jose de la Torre, *U.S. Refusal to Join Financial Services Pact is a Big Mistake*, LOS ANGELES TIMES, Sept. 3, 1995, at D1. The commitments made by the signatory countries are interim in nature and will remain in effect until December 31, 1997 at which time the countries will renegotiate their commitments. Trachtman, *supra* note 32, at 55.

<sup>83</sup> Williams, *supra* note 82. Specifically, the refusal of East Asian developing nations to ease stringent restrictions on entry prompted the U.S. withdrawal. *Id.* See *U.S. Complains at WTO of Few Offers to Open Up Financial Services Markets*, BNA INT'L TRADE DAILY, Mar. 29, 1995 (explaining that developing countries preferred a phased liberalization process to that the development of their domestic banks would not be threatened by foreign institutions).

<sup>84</sup> Williams, *supra* note 82.

<sup>85</sup> *Id.*

<sup>86</sup> See Trachtman, *supra* note 32, at 53 (explaining while GATT was originally intended to "complement the monetary policy work of the IMF," GATS has only begun to address the regulatory and monetary concerns needed for the liberalization of trade in financial services).

appropriate, recognition should be based on multilaterally agreed criteria."<sup>87</sup> Additionally, GATS mandates that in these situations the "Members shall work . . . towards the establishment and adoption of common international standards and criteria for recognition . . . ."<sup>88</sup> As the recent Daiwa and BCCI incidents emphasize, determining standards for banking supervision is clearly an 'appropriate' situation for multilateral negotiation. The Daiwa incident indicates that while mutual trust is essential to international banking supervision, it is not enough because even an honest misunderstanding as to expectations has the potential for negative consequences.<sup>89</sup> In order to foster and encourage the GATS liberalization process, there should be a definitive set of legally binding rules and standards that countries can point to in order to ascertain exactly what they can expect from others and what is expected of them. If international standards are not developed, there is a risk not only that the U.S. policy of welcoming foreign banks into the U.S. market will become increasingly criticized by the American public,<sup>90</sup> but also that, because of the indisputable need for the liquidity that foreign banks provide, industrialized nations will form increasingly stringent standards which only other "club" members will be able to meet.

The WTO provides an appropriate forum for the development of these standards because the negotiators are given the authority to enter into multilateral binding agreements as opposed to a set of principles that the parties are only "ethically" bound to implement. Another benefit of the WTO is that it provides a multilateral forum, in which both developing countries and industrial countries can participate.<sup>91</sup> While the industrialized countries will undoubtedly have the most input into the supervisory standards, Members are obliged to "facilitate the increasing participation of developing countries."<sup>92</sup> Finally, developing countries will be given the opportunity gradually to expand their operations without the correlative risk

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<sup>87</sup> GATS, *supra* note 22, art. VII:5.

<sup>88</sup> *Id.*

<sup>89</sup> Hearings, *supra* note 12. Over the past decade Japan's share of the U.S. market doubled so that it now exceeds \$780 million because of the fact that the U.S. regulators believed they could rely on Japanese authorities for trust and cooperation.

<sup>90</sup> See *supra* text accompanying notes 62-65 and 84-85 (explaining that despite the U.S. withdrawal from the financial services agreement, the U.S. market is open to foreign institutions and that the U.S. is committed to global liberalization).

<sup>91</sup> This is a marked difference from the Basel Committee which is comprised solely of the banking supervisors from industrialized nations.

<sup>92</sup> GATS, *supra* note 22.

of their own markets becoming controlled by foreign banks; this risk is alleviated by the commitment Members made to take into account the particular need of developing countries to exercise the right to introduce new regulations to meet national policy objectives.<sup>93</sup>

#### IV. CONCLUSION

The Daiwa incident re-emphasizes the need for the development of international supervisory standards. The increased intertwining of global capital markets has resulted in heightened foreign investment and liquidity, but it has also introduced the correlative risk that poor supervisory standards in one nation can have potentially devastating effects abroad. International regulatory standards would allow nations to continue to attract foreign investment, avoid perceived "protectionist" legislation, and maintain the stability of the banking industry. While the Basel Committee guidelines and recommendations have greatly benefited the international banking community, the time has come for a legally binding set of concrete rules to which various national supervisors can turn in supervising both domestic and foreign banking establishments. These concrete rules are necessary because, as the Daiwa incident demonstrates, even a good faith misunderstanding on the part of one supervisor can have potentially global dramatic consequences.

The development of international standards is not only necessary in order to help Member States continue their commitments to the progressive liberalization of the financial sector, but it is also necessary to protect against the risks that this progressive liberalization entails. Standards would allow countries to draft their legislation so that it would conform to the GATS transparency principle. The implementation of these standards would serve to protect national legislation from allegations of protectionism.

The World Trade Organization provides the appropriate forum for the negotiation of these standards because it is a multilateral forum in which countries are represented by representatives who have the authority to bind their respective governments. The use of the WTO would allow both the industrialized and developing countries a neutral forum in which all members would have an equal voice in the standard drafting. While the current countries whose supervisors comprise the Basel Committee are likely to have the most input into the drafting process, the Members are obliged to facilitate the participation of developing countries. Another benefit of the WTO is

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<sup>93</sup> *Id.*

that it would allow Members the use of the dispute settlement system with the possibility of compensation if Members do not comply with their obligations.<sup>94</sup> The Member States should take the opportunity to use the WTO to formulate international supervisory standards to complement their GATS commitments without sacrificing the integrity of their financial systems. These standards would prevent the possibility of a less efficient protectionist market, a global decrease in liquidity and the further development of an exclusive "club" of supervisory authorities.

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<sup>94</sup> *Id.* art XXIII.

