

BCCI CASE AND THE INTERNATIONAL SUPERVISORY ARRANGEMENTS
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[B]anking establishments are more dangerous than standing armies.
Thomas Jefferson (1816)

1. Introduction

As is well known, the BCCI (Bank of Credit and Commerce International) - the so-called 'bank within a bank' - specifically intended to be the largest Islamic bank in the world was closed down in 1991 in the context of the discovery of pervasive fraudulent practices (ICR, 1994).

The event was possibly the most important international banking collapse of all time, certainly the biggest case of banking fraud and the first occasion in recent times that a large European-based bank had been allowed to default on ordinary depositors.

International concerns of bank regulators have rested largely on policy means of facilitating the "safe and sound development of an international banking system" through the promotion of stability within such system, and of ensuring competitive equality among international banking institutions (Norton et al.,1993). Banking is one of the most heavily regulated of all industries. At the

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same time, however, excessive restraint on banking imposes needless costs on the financial system, increases the spread between borrowing costs and depositor returns, and ultimately risks reducing economic growth (Broadus, 1994). It should be borne in mind that the failure of one or more banks may result in a run on other banks. It also should be noted that the prevention of bank runs and failures may increase financial stability (Benston, 1991). Therefore some aspects of current -international- bank regulation and supervision clearly are flawed and had been in need of revision.

From this perspective, this study will attempt to review the success of both the EC and Basle Committee closing the 'loopholes' in international regulatory and supervisory arrangements which BCCI clearly took advantage of.

2. About the BCCI

BCCI was established in 1972 by a group of Pakistani bankers with capital contributions from Bank of America and substantial Middle East investors. By 1990 BCCI was one of the largest private banks in the world, with stated assets of around \$20bn, and branches operating in some seventy countries. This global banking network was managed through an unusual corporate structure (Dale, 1992). While the parent holding company was established in Luxembourg (BCCI Holdings), the main banking business was divided into two incorporated subsidiaries as BCCI SA in Luxembourg and, BCCI Overseas in Cayman Islands. On the other hand shareholders were based in the Middle East and the operating headquarters in London UK.

Since 1970s there had been complaints that BCCI was poorly regulated. One reason was that each regulator had only a limited view of the group. There was a similar problem for auditors. For most of BCCI's existence, the Luxembourg holding company and bank were audited by Ernst&Whinney (then called Ernst & Young). Another firm, Price Waterhouse, audited the Cayman Islands holding company (Truell, 1992).

Bank regulators were largely oblivious of BCCI's practices. Mr. *Abedi* (the Pakistani financier founded and led BCCI) had organised BCCI in such a way that no single regulatory authority had a world-wide view of its activities.

3. How BCCI evaded the International Supervisory Arrangements [Basle Concordat] ?

In 1983, the Basle Committee on Banking Supervision (see *Annex*) published its document entitled "Principles for the Supervision of Banks' Foreign Establishments" known as the 'revised Basle Concordat' which replaced the

1975 Basle Concordat [Report to the Governors on the Supervision of Banks' Foreign Establishments].

The new document gave primary responsibility for monitoring the liquidity of foreign branches, subsidiaries and joint ventures to host supervisor; while it gave the parent supervisor the primary responsibility for monitoring the solvency of foreign branches. And it required that both the parent and the host supervisor must share responsibility for monitoring the solvency of foreign subsidiaries, as well as monitoring the foreign exchange operations and positions of foreign branch offices.

The revised Concordat not only assigned various supervisory functions to either or both the parent and host supervisors, calling for both to co-operate and exchange information, but also stated that it was the responsibility of the parent supervisor to oversee a bank's world-wide operations. The Concordat recommended that the parent authority should provide consolidated supervision which means monitoring the risk exposure (including the concentrations of risk, the quality of assets and the capital adequacy) of the banking groups for which the parent authority bears responsibility, on the basis of the totality of business, wherever conducted. Furthermore, the revised Concordat went as far as to state that where the host supervisor believes the home supervision of foreign banks operating within its territories to be inadequate, it should prohibit or discourage the banks' continued operation, or impose restrictions on the banks activities its territory (ICR,1994).

As pointed out above, despite the fact that BCCI was headed by the Luxembourg based holding company, neither the holding company nor the Luxembourg subsidiary conducted business in Luxembourg. A world-wide network of branches operated in over 70 countries including the United Kingdom, where the bank conducted much of its business.

The -opaque- corporate structure established by BCCI had the effect of minimising close supervision of the full range of its operations, and is believed to have enabled it to avoid detection of its true operations and condition for almost two decades. For instance, BCCI could remove transactions from the accounts of BCCI units in other countries, thereby shielding the relevant activities from supervisory review and external audit.

Complicated organisational structure of the BCCI successfully hampered its supervision on a consolidated basis and, exploited the lack of a parent authority capable of performing internationally consolidated supervision over the banking group as a whole.

As Herring (1993) emphasises that the BCCI had already entered most major markets before the revision of the Concordat in 1983.

4. The EC Response to the BCCI Débacle

With the advent of the European Financial Common market, the collapse of BCCI was a timely reminder of the need for competent banking supervision and adequate investor protection (Henderson, 1993).

With the BCCI affair the questions raised about supervisory standards within the EC since under the Second Banking Co-ordination Directive, which allows banks incorporated in one Member State from the beginning of 1993 have the automatic right to branch into other Member States. Under this regime host countries will be unable to restrict or terminate the operations of such a branch - except in the extreme case where it is in persistent breach of the host country's criminal law (Dale, 1993).

In order to meet concerns in this area the EC has strengthened arrangements for consolidated supervision through a newly adopted and revised Second Consolidated Supervision Directive (92/30/EEC). This Directive specifically addresses *two* weaknesses in the regulation of BCCI, first, by bringing non-bank financial holding companies into the regulatory framework and second, by stating that where the bulk of a bank's business is conducted outside the home country, the host country with the largest share of that business should become the lead regulator responsible for exercising supervision on a consolidated basis.

At the same time the Directive is aimed to enhance the effectiveness of consolidated supervision exercised in respect of banks operating in the EC by: (i) extending the range of circumstances under which credit institutions have to be supervised on a consolidated basis; (ii) extending the scope for information exchanges both between supervisory bodies in the EC and between them and non-EC supervisory bodies; (iii) clarifying the lead regulation position for banking groups of all kinds, including those with non-bank parents; and (iv) generally clarifying the obligations and responsibilities of both host and home supervisory authorities, especially in the sharing of information (Hall, 1994).

The BCCI collapse has also prompted the European Commission to bring forward proposals (now agreed) for a Deposit Insurance Directive. This is intended to provide incentives for national supervisors within the EC to maintain high supervisory standards by making the home country responsible for insuring deposits of branches established elsewhere within the EC.

After the creation of Europe's single market in 1992, the EC's second banking directive stipulates the home country greater responsibility for assuring the safety of its own banks (Kochan, 1991).

5. The Basle Response to the BCCI Debacle

In 1992, following the closure of BCCI, the Basle Committee on Banking Supervision issued a document entitled 'Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments'.

This further document reinforced the previous documents containing recommendations based on the premise that secrecy constraints should be removed to allow supervisors to exchange prudential information freely, subject to certain conditions intended to protect the providers and receivers of the information. These standards have been summarised by the Committee as follows :

1. A home country authority which capably performs consolidated supervision should supervise all international banking groups and international banks.

2. The creation of a cross-border banking office should receive the prior consent of the prior consent of the bank's supervisory authority and, if different, the banking group's home country supervisory authority.

3. Supervisory authorities should have the right to gather information from the cross-border banking offices of the banks or banking groups for which they are the home country supervisor.

4. A host country authority which determines that any one of the prior minimum standards is not met, can impose restrictions on the bank, including prohibiting the bank from establishing any offices within the host country's jurisdiction.

The key requirement is that all international banks should be supervised by a home-country authority 'that capably performs consolidated supervision'. This is further spelt out as meaning that the authority concerned should (a) monitor banks' global operations on the basis of verifiable consolidated data; (b) be able to prohibit the creation of corporate structures that impede consolidated supervision; and (c) be in a position to prevent banks from establishing a presence in suspect jurisdictions.

If the minimum standards are not met, the host authority is called on to exclude banks from the jurisdiction concerned or alternatively to accept responsibility for supervising these banks' local operations, subject to appropriate restrictions (which may, by implication, include mandatory incorporation of such operations).

There are two potential obstacles to the effectiveness of the new Basle guidelines. In the first place, national authorities will have to show a greater willingness than in the past to exercise their powers of exclusion. In this context it is too early to say whether non G-10 countries, faced by the threat of being shut out of the major banking centres, will be prepared to conform to the Basle minimum standards. The second potential difficulty concerns the capacity of national authorities to monitor each other's quality of supervision. Under the Basle guidelines this is supposed to be done on the basis of the other authority's statutory powers, administrative practices and its record. But there is no new multilateral machinery to assist in the monitoring process and it is difficult to see how bilateral relationships can provide adequate information about supervisory standards in particular jurisdictions.

At present the only degree of co-ordination is based on gentlemen's agreement of the Basle Concordat between the G10- group of ten industrialised nations. The Concordat allocates responsibilities between parent and host supervisory authorities, with everyone policing their own little corner. Its influence is limited precisely because it is nothing more than a gentlemen's agreement (Kochan, 1991).

6. Policy Recommendations

As Hall (1994) points out, there should be some independent monitoring of supervisory standards. Banks operating in financial centres offering 'impenetrable secrecy' should generally be refused authorisation or otherwise have it revoked.

The arrangements governing the exchange of information between international supervisors should be improved. Hence an international database listing those individuals deemed by national supervisors not to be 'fit and proper' for the purpose of operating as a director, manager or controller of a bank should be established.

All payment instructions passing through a correspondent bank should show the name of both the originator and the beneficiary by (a) providing independent monitoring subject to the supervisory standards, (b) enhancing the international supervisory co-operation and, (c) tackling the problem of bank secrecy provisions.

It will be beneficial to the reader to summarise Norton et al. (1993)'s certain preliminary observations concerning why there appears to be growing tendency, domestically and internationally, toward embodying supervisory standards in formal legal regulation :

1. Public and political significance,

2. Improvement of quality of regulation,
3. Consistent fulfilment for regulatory policy,
4. Greater transparency,
5. Conditions for competitive equality,
6. Effective regulatory enforcement,
7. Fairness and protection of private rights and,
8. Stable convergence vehicle (for implementing goals for the international convergence of bank supervision standards).

And it is also necessary to restate some basic observations as Hall (1994) points out :

1. That the Basle concordat be revised yet again to accommodate the following demands:

(i) that every international bank or banking group be allocated a suitable lead regulator;

(ii) that the responsibilities of home and host supervisors be specified more precisely;

(iii) that adequate resources be devoted to banking supervision;

(iv) that minimum standards of supervision be exercised by all supervisory authorities.

2. That the BIS formally monitor the supervisory standards applied around the world.

3. That the EC's draft Consolidated Supervision Directive be implemented as soon as possible, and that the Commission's proposals for a harmonised deposit guarantee scheme, embracing the principle of home country responsibility for the protection of deposits held both at home and in branches overseas, also be introduced as soon as possible.

4. That further measures be taken by supervisors to strengthen bilateral agreements, particularly with a view to facilitating effective consolidated supervision of banks or banking groups straddling EC and non-EC borders.

5. That the case for establishing a supra-national supervisory authority (maybe the European Central Bank) in the European Community be examined further by the Commission.

As Bellanger (1992) pointed out the Basle Committee on Banking Supervision as the most important international supervisory body has no legal enforcement powers. The EC has the legal power to make and enforce bank regulation on a multicountry basis by issuing directives which will ensure the safety and the soundness of the system.

Thus, a large part of the regulation and supervision of financial institutions should be related to preventing fraud and excessively risky behaviour (Benston, 1991).

In order to overcome the problem of the monitoring of each other's quality of supervision, the Bank of England has proposed a system of peer group review under which each country's supervisory arrangements would be assessed by a panel of supervisory authorities from other countries. However, it is as yet unclear whether this kind of approach would have the broad support among non-G-10 countries that would be needed to make it viable (Dale, 1993).

7. Conclusion

The main lesson of the BCCI affair is that a bank structured in a way that makes effective supervision impossible should not be allowed to expand to become a \$20 billion institution (Dale, 1993) and, although the BCCI had more regulators than many other banks, shared supervision in reality meant little or no supervision (Henderson, 1993).

The closure of the BCCI has revealed that while the banking industry has expanded and developed, world-wide banking regulation has not (Alford, 1992).

The BCCI was structured in such a way that no single central bank was able to monitor its activities. No foreign bank should be permitted to operate in the world unless it is supervised by a single, strong, central bank and is not bound by bank secrecy laws of another jurisdiction. Without these reforms the potential for massive world-wide bank fraud remains.

With banking activities increasingly globalised, problems in one bank or banking group can be detrimental to financial entities in many countries.

Several failures have in any case increased the potential for systemic failure in the international banking sector. For instance greater linkages exist between various markets, as banks interact with NBFIs, including investment banks and insurance companies, domestically and across borders.

In the aftermath of BCCI, the regulatory response at both multinational and national levels has been to impose more stringent authorisation requirements on branches of foreign banks, based on assessment of the quality and scope of home country supervision. However, the effectiveness of these new arrangements will depend largely on host countries' ability to monitor supervisory standards world-wide and it is here that the Basle Committee's emerging role as a regulatory watchdog will become crucially important. If the Basle approach proves inadequate to the task (and it should be emphasised

here that the BIS has no formal supervisory authority over the banks which own it or over banking supervisory authorities) then there may eventually be pressures for an independent international regulatory and supervisory body to conduct formal reviews as part of its country surveillance procedures.

Experiences showed that cross-border supervisory developments are driven in practice by banking scandals.

ANNEX

The Basle Concordat System:

Basle Committee on Banking Supervision has maintained its lead as the primary global forum for enhancing the effectiveness of banking supervision. Its main purpose is to help encourage greater co-ordination among international banking supervisors. The Committee pursues this objective by (a) facilitating the exchange of information among supervisors on the various national bank supervisory practices, (b) encouraging safe and sound national regulatory policies and practices, (c) developing general principles for the adequate supervision of international banks and, (d) developing standards for bank capital and other aspects of banking.

Basle Committee has issued the following guidelines :

1. The Basle Concordat of 1975: 'Report of the Governors on the Supervision of Banks' Foreign Establishments'.
2. The Basle Concordat of 1983 [the 'Revised Concordat']: 'Principles for the supervision of Banks' Foreign Establishments'.
3. Supplement to the Concordat, 1987/1990: 'Recommendations Concerning the Removal of Secrecy Constraints'.
4. The Capital Adequacy Accord, 1988: 'International Convergence of Capital Measurement and Capital Standards'.
5. The Minimum Standards Statement, 1992: 'Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments'.

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