GREAT FINANCIAL DEPRESSIONS AND EFFECT OF BASEL ACCORDS IN THE PRESENT COMMERCIAL ERA

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1. INTRODUCTION

International banking has been galvanized in recent decades, which has necessitated the need of global supervision in the current intercontinental commerce. Commerce in its modern form first appeared in early 13th century when conducive political conditions existed. Trade facilitated the exchange of goods, thereby enhancing the efficiency of processes between production and consumption. Even more important was its role in raising the level of human capital, promoting the spread of ideas and information, changing people's attitudes and behaviour. Some modern business practices institutions which evolved with modern commerce are bookkeeping, modern banking, commodities market, putting out systems (or outsourcing as we know it now), insurance, stock exchange, and venture capital.

In the field of monetary law, economic definitions and theories have often found their way into the law through the adoption or reform of monetary legislation.[1] In the recent years the element of monetary stability has further spur the pursuit of the objectives of institutional arrangements, central banking and formulation of monetary policies, which are generic to the economic policies being undertaken by the politicians of any country. Furthermore, it has become generally accepted that the primary objective of monetary policy as an instrument of economic policy should be price stability. Most modern central bank laws refer to this goal as their most important objective. This is based on economic theory (vertical Phillips curve in the long run and time inconsistency) and supported by empirical evidence: independent central banks do a better job than politicians at controlling inflation.[2] Thus, the sovereignty of central banks is imperative for an economic stability, which would otherwise be a fiasco if not followed. We witness a similar situation in the current time whereby the financial deterioration has caused many gigantic financial institutions to collapse.

The fragility of the banking industry is a permanent feature in financial history. In his authoritative record on the recurrent nature of crises, Charles Kindlesburger described how displacement, euphoria, distress, panic and crisis have occurred decade after decade, century after century.[3] A sound financial system is essential for monetary and financial stability. However, since the banking industry is inherently unstable, the authorities always need to be prepared to confront the possibility of crises or problems. Over the years a number of preventive and remedial instruments have been devised strengthen the banking system and to defend it against any negative contingencies.[4]

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[1] See Legal Foundations of International Monetary Stability by Rosa M. Lastra: Development at the National Level pp 34.
[2] See Rosa M. Lastra, *CENTRAL BANKING AND BANKING REGULATION* (London: Financial Markets Group, London School of Economics, 1996) pp 13-24.
[3] See Charles P Kindlesberger, *Manias Panics and Crashes*. A HISTORY OF FINANCIAL CRISES, 3rd edn. (New York: John Wiley & Sons, 1996).
[4] See Legal Foundations of International Monetary Stability by Rosa M. Lastra: Development at the National Level pp 110.

NEED FOR EFFECTIVE INTERNATIONAL FINANCIAL REGULATION

The breakdown of Bretton Woods fixed exchange rate system in 1971-73 made imperative the international regulation of financial markets. The elimination of fixed exchange rate parity with gold resulted in the privatization of financial risk, which created pressure to eliminate controls on cross border capital movement and the further de-regulation of financial markets.[5] It became necessary for national regulatory authorities to promote safe and sound banking system through the effective management of systemic risk in the national markets. In this regard the G-10 countries took the lead by adopting international Minimum Standards of prudential supervision.[6]

The collapse of Bretton Woods had created interest rate instability in global markets by 1974. Although, since early 70s and, in particular, the suspension of dollar convertibility, banks and all other operators in international financial markets had been exposed to new levels of currency and interest rate risks.[7] The effect of the abolition of the Bretton Woods arrangement was that the dollar devalued substantially overnight. As OPEC oil contracts were dollar denominated, one immediate effect of this was that the oil producing countries had to raise the oil prices to compensate for their otherwise loss in earnings.[8]

With the high new levels of currency and interest rate risks, which began during the early 1970s, the stability and effective operation of the new international financial markets were only properly tested for the first time. Dramatic attention was, in particular, drawn to the inherent instability of the new international financial order (or disorder) with the closure of Franklin National Bank in the United States and of I.D. Herstatt in Germany during the summer of 1974.[9] Rather than attempt to construct any formal or more complete response to the new exposures and challenges created, the principal trading financial nations felt constrained to proceed on a more gradual and selective basis. It was accordingly decided only to establish an initial contact and communication vehicle with the Basel Committee in December, 1974.[10]

The lack of a coherent international regime to provide standards for the risk-taking activities of financial institutions has exposed financial systems to an increased risk of systemic failure. Indeed linkages amongst the world's financial markets have led to a significant expansion in the number, size and types of activity, and in the organizational complexity of multinational financial institution.[11] Thus an international interface is eminent in order to secure an effective cross-border transactions and international linkages. The formation of Basel Committee was result of potential bankruptcy which took in the post world war II era. From 1965 to 1981

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[5] Alexander K. *The Need for Efficient International Financial Regulation and the Role of a Global Supervisor,* Journal of Money Laundering Control, 2001, Vol. 5, No. 1, pp 52-65.
[6] Estwell J. & Taylor, L. (2000) 'Global Finance at Risk: The case for International Risk', Policy, Cambridge, pp 21-23.
[7] E.P. Davis, *Debt, Financial Fragility and Systemic Risk* (1992), p. 154.
[8] Walker G.A. *International Banking Regulation: Law, Policy & Practice* (2001), Kluwer, The Hague/London/New York, pp 24-25.
[9] Walker G.A. *International Banking Regulation: Law, Policy & Practice* (2001), Kluwer, The Hague/London/New York, p 17.
[10] See Basel Committee, *Compendium of Documents* (April 1997), Volume 1, pp 17-57.
[11] Kern Alexendar, *The Need For Efficient International Financial Regulation and the Role of Global Supervisor,* Journal of Money Laundering Control, 2001, Vol. 5, No. 1, pp 52-65.

there were about eight bank failures (or bankruptcies) in the United States. Bank failures were particularly prominent during the'80s, a time which is usually referred to as the "savings and loan crisis".[12] For the prevention of the risk of bankruptcy and for an efficient international banking the banking supervisors of G-10 countries, who constitute Basel Committee on Banking Supervision, met in 1987 in Basel, Switzerland and the outcome of the meeting was Basel-I Capital Accord. This accord mainly concentrated on defining the bank capital ratio. Furthermore, it had its emphasis on linkages of cross-border supervision and the support for banks facing liquidity difficulties and how to exchange international information about the foreign activities of banks.

Despite all efforts taken by Basel Committee on banking supervision the international financial institutions and banking companies could not have stopped a further recession. Moreover, the fall of BCCI in 1991 had further aggravated the situation, which had occurred in the post Vietnamese War time, when the ninth largest bank of USA had gone bankrupt. BCCI came under the scrutiny of regulatory bodies and intelligence agencies in the 1980s due to its perceived avoidance of falling under one regulatory banking authority, a fact that was later, after extensive investigations, proven to be false. BCCI became the focus of a massive regulatory battle in 1991 and was described as a "$20-billion-plus heist". Such occurrences in the global economy supposedly had lost the efficacy of Basel –I Capital Accord. Thus in lieu of its apparent failure the Basel Committee had drafted a second paper in 1998 as Basel –II Capital Adequacy Accord, which was to be implemented in 2007. After commentary from the banking sector and government regulators, the Basel Committee released a further revision of the proposed reforms to the Capital Accord on 06th January, 2001 (known as the new Capital Accord).[13] The Basel-II was conceived with an idea of mitigating the systemic risk, which occurs because of inadequate capital and exposures beyond the restricted limits with the banks. Thus, the Basel Core Principals were proposed and adopted under seven different headings as follows:[14]

Precondition for Effective Banking Supervision	Principal 1
Licensing & Structure	Principal 2-5
Prudential Regulation & Requirements	Principal 6-15
Methods of ongoing Banking Supervision	Principal 16-20
Information Requirements	Principal 21
Formal Powers of Supervisors	Principal 22
Cross Border Banking	Principal 24-25

The above principals, though not practically applicable with the supervisors of developing countries, did devise a way forward to allay the risk of financial institutions going bankrupt. The Basel Core Principals are comprehensive from the point of view of banking supervision. These principals are addressed to the central supervisory bank and are very much in line and supplement in many respects

[12] Fadi Zaher, *Does the Basel Accord Strengthen Banks?* http://www.investopedia.com/articles/07/BaselCapitalAccord.asp (last viewed on 09-09-09, 11:37 am)
[13] See '*The New Basel Capital Accord*', www.bis.org.
[14] The text of Core Principals has been produced in 37 *International Legal Materials* (1997) 405.

the EC Second Directive, particularly in regard to capital adequacy and responsibilities of the supervisory authorities.[15]

SYSTEMIC RISK & BASEL CORE PRINCIPALS

Systemic Risk (contagion risk) in a general sense is a phenomenon not confined to economics or to the financial system.[16] As has been stated in the preceding paragraphs that the banks take up risks, which is non-congruent to an international interface, ultimately tantamount to spill over to a large number of other banks or the financial systems as a whole. Though the core principals provide some fortification and mitigation to this risk but in the current times these principals have not been implemented in its full form because of the fact that they are recommendatory in nature. In addition to this it would be difficult for many advancing countries to implement the core principals in their entirety, though there is always a room available for improvement.

Despite the above-mentioned two accords by the Basel Committee or the G-10 supervisors, a little effect has been seen in the first financial crunch of this century. Since the financial depression of 1882 and more notably, the recession of 1933[17], there has been an immense change both in technology and banking system. Furthermore, the initiations to reform the financial regulations globally by Basel Committee have rather galvanized the processes and in such a scenario an efficient system of financial operations should have been developed, but the current situation is to the contrary.

Implicit in the Basel Core Principles is the risk that a supervisory authority must control and manage: credit risk, transfer risk, market risk, interest rate risk, liquidity risk, operational risk and legal risk. Some of these risks are relevant to inter-country activities, and in particular between banks in developed countries and developing countries.[18] Thus the efforts of Basel Committee to this point have not been effective as global regulator and all authors of global economy are also off the view that the core principals are not applicable in whole. Currently, the banks and the financial institutions are filing bankruptcies and there is an immense level mergers and amalgamations of corporate entities, which is a clear depiction of the deteriorating global economy, which is moving to inflation in most parts of the world.

CONCLUSION

Fred E Foldvary had envisaged in his article that the US economy will face the worst ever recession in the year 2008, giving thorough reasons of the same.[19] Its practically not possible for the third world countries or the developing countries to

[15] Chatterjee C, *The Basel Core Principals for Effective Banking Supervision: an analysis,* European Financial Services Law, 1999, Vol. 6, No. 2, pp 78-84.
[16] Rosa M. Lastra *Legal Foundations of International Monetary Stability*: Development at the National Level, Ch. 4: *Banking Crises & Stability of Financial System* pp 138.
[17] John F. Tinsley *Depressions Past & Present*: Bulletin of the Business Historical Society, Vol. 7, No. 2 (Mar, 1933), pp 2-13, Published by The President and Fellows of Harvard College.
[18] Chatterjee C, *The Basel Core Principals for Effective Banking Supervision: an analysis,* European Financial Services Law, 1999, Vol. 6, No. 2, pp 78-84.
[19] Fred E. Foldvary, *The Depression of 2008,* Sec. edn, Sept, 18, 2007, pp 3-32.

follow the same pace, the developed countries have acquired. Furthermore, the sharing of information between the supervisors of developed countries and the developing countries is a sine qua non to the prevention of such recessions. Basel Committee needs to formulize the working in a manner that the representatives of developing countries have full representation and a conglomerate is formed to materialise the effective cross border financial interactions. Global economies also face the threats of money laundering, thus the Basel Committee has to be meticulous in devising the financial package, which is practically acceptable around the globe. Minus these reservations, not even Basel-III (proposals being prepared) will prevent the global economy from entering into another recession in not more than a decade.