

# Eastern Market: THE INTERACTION BETWEEN THE BASEL COMMITTEE ON INTERNATIONAL BANKING REGULATION AND THE OPENING OF THE CHINESE BANKING MARKET

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## I. INTRODUCTION

Since the global currency crisis of the 1970s, the directors of the world's largest central banks have met in Basel, Switzerland to promulgate international standards governing the global banking system.<sup>1</sup> Though the Basel Committee on Banking Supervision ("Basel Committee") does not have formal legislative power,<sup>2</sup> over one hundred nations adopted the first comprehensive Basel Capital Accord ("Basel I"), effectively meaning that the Basel Committee's regulations govern the global banking sector.<sup>3</sup>

Now the banking world is moving East, and China's accession to the World Trade Organization ("WTO") will lead to the opening of a vast, rich market for banking.<sup>4</sup> However, with the emergence of great opportunities in China come the challenges of integrating a growing, newly free-market economy into the international banking market—an essential market which has fueled the economic progress of the West and Japan since the end World War II.<sup>5</sup> As the banking world continues to globalize, the Basel Committee must consider the effects of international banking on the Chinese market.<sup>6</sup> The Basel Committee's promulgations are binding international law because the Committee occupies and controls a broad expanse of power and regulation over the international banking sector.<sup>7</sup> As the primary international bank regulation, the most recent Basel Committee framework ("Basel II") fails to sufficiently require capital adequacy requirements and robust deposit insurance as the Chinese banking market opens to the West.<sup>8</sup> An institution developed and traditionally staffed by Western banking regulators, the Basel Committee must now grapple with issues presented to banks originating in less developed economies as the next step in the globalization of the banking marketplace.<sup>9</sup>

Part II of this Comment will describe the need for international banking regulation,<sup>10</sup> the historical impetus and development of the Basel International Banking Regulations,<sup>11</sup> and the current banking sector in China.<sup>12</sup> Part III of this Comment will argue that Basel is binding customary international law,<sup>13</sup> analyze the effect that the implementation of soft capitalization requirements will have on the Chinese banking sector,<sup>14</sup> and consider China's competitive disadvantage due to the existence of non-



performing loans.<sup>15</sup> Part IV of this Comment will recommend that the Basel Committee update its regulations in order to confront the unique problems Chinese banks will pose to the global banking sector.<sup>16</sup> Finally, Part V will conclude that the Basel Committee should act with conclusive legal force to strengthen capitalization requirements and ensure strong deposit insurance requirements worldwide.<sup>17</sup>

## II. BACKGROUND

The international banking system has developed into an integrated global system since World War II.<sup>18</sup> Since the creation of this global market, banks have evolved from simple institutions for consumer and corporate deposits and lending to large investment institutions with complex asset and liability portfolios.<sup>19</sup> The unique characteristics of the Chinese market pose new challenges to multinational banks as they enter the market.<sup>20</sup>

### A. Capitalization of Assets and Deposit Insurance in International Banking

In their most basic form, banks are institutions that take deposits and issue loans.<sup>21</sup> A depositor gives the bank its money with the understanding that he will be able to retrieve that money; the bank then invests that money in assets, usually loans.<sup>22</sup> A bank makes a profit by assessing the repayment risk of loans, but it must retain some capital to ensure solvency and the ability to return deposits to customers on demand.<sup>23</sup>

In a theoretical free market, the percentage of capital necessary can be determined by the market, because investors would only deposit funds if a bank's capitalization ratio was not overly risky.<sup>24</sup> However, banks have become an essential part of the global financial infrastructure and of the daily life of most citizens of the industrialized world.<sup>25</sup> A complex regulatory framework governs banks to protect them from failure and to protect citizens' deposits in case of failure.<sup>26</sup> Effectively, the risk of bank failure rests squarely on the government because government sponsored insurance programs (the Federal Deposit Insurance Program (FDIC) in the United States) protect virtually all deposits.<sup>27</sup> The insurance of bank deposits has become a necessary part of an increasingly complex financial system.<sup>28</sup> However, with the insurance of deposits, governments also regulate the capitalization of bank assets.<sup>29</sup>

Critics suggest that the issuance of deposit insurance by governments removes the market constraint which prevented banks from investing in overly risky enterprises.<sup>30</sup> If a bank now loses depositors' money in the process, the government insurance will pay the depositors.<sup>31</sup> As a result, experts argue that with insurance there is no longer a market incentive for depositors to choose their banks based on risk.<sup>32</sup>

Governments solve this problem by mandating that banks retain a certain proportion of their assets with no risk of loss (capitalize) and by regulating the investment risks banks take with their assets.<sup>33</sup> As the banking business globalizes, the central banking institutions responsible for regulating banks in specific nations recognize the potential for abuse if these regulatory requirements do not also globalize.<sup>34</sup> For example, critics suggest that changing national regulations could leave domestic banks vulnerable to threat from countries with perceived or actual favorable regulations; and, nations with those advantages would be remiss to change their regulations absent a destabilizing crisis in the banking sector.<sup>35</sup>

## **B. The Basel Committee**

The central bankers from the largest ten banking nations recognized the need for international unity in bank regulation, establishing the Basel Committee to promulgate international regulations and to close gaps created by differing standards across national borders.<sup>36</sup> The Basel Committee creates regulations by consensus and implements them through the authority of its members.<sup>37</sup> Its stated purpose is "to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide."<sup>38</sup>

The modern banking system has its roots in the aftermath of the market-dominated West winning global wars against totalitarianism, rebuilding a battered continent, and encouraging the reemergence of European economic power.<sup>39</sup> Critics suggest that the current banking system will be challenged with the rising incorporation of developing nations to the global system, such as a decreasingly controlled Chinese market.<sup>40</sup>

### ***1. Banking Post-World War II: The Rise and Fall of the Bretton-Woods System and the Creation of the Basel Committee***

Initially following World War II, the Bretton-Woods system tied U.S. dollars to gold and most world currencies to the dollar, creating a stable environment for the United States to lead the rebuilding of Western Europe.<sup>41</sup> However, as European nations regained economic power and U.S. investment in foreign companies grew, the Bretton-Woods system began to break down.<sup>42</sup> Powerful European nations created a Eurodollar market, which put the defined value of the dollar into question by allowing it to be traded in the open market.<sup>43</sup> Currency exchange disabled the Bretton-Woods system, and the need for an internationally governable system to replace the dollar-centric gold standard became apparent.<sup>44</sup>

In 1988, the Basel Committee created a formulaic structure for international banks to regulate their risk and retain necessary capital assets ("Basel I").<sup>45</sup> The preliminary framework required capitalization of assets at eight percent of value, adjusted for risk based on categorization of similar assets.<sup>46</sup> In other words, Basel I required banks to discount the value of less-risky assets before calculating their capitalization requirement.<sup>47</sup> The Basel I framework required that assets subject to market risk be categorized based on the risks they presented to the bank.<sup>48</sup> Further, banks had to capitalize at least half of their assets as "Tier 1,"—effectively stockholder's equity and "qualified, noncumulative, perpetual preferred" stock.<sup>49</sup> The other half of assets capitalized could be either more Tier 1 assets or they could fall into the broader array of assets allowed by Tier 2—including undisclosed reserves, revaluation reserves, general provisions or general loan-loss reserve, hybrid debt capital instruments, or subordinated term debt.<sup>50</sup>

In a theoretical free market, the percentage of capital necessary can be determined by the market, because investors would only deposit funds if a bank's capitalization ratio was not overly risky.

### ***2. Basel II: The Post-Modern International System and the Complex Modern Financial Risk Assessments which Better Serve Large Multinational Banks***

Critics suggest that the most important innovation in the Basel II framework is the transition from defined categorical risk assessments to fluid internal risk assessments.<sup>51</sup> Where Basel I categorized types of capital investments,<sup>52</sup> Basel II attempts to

take a more market-based approach that relies on complex risk management practices by banks.<sup>53</sup> The Basel Committee sought to change the framework of risk definitions because the growth and expansion of international banking and the proliferation of complex investment mechanisms amplified the drawbacks of pigeon-holing capital investment into narrowly defined categories.<sup>54</sup> The United States determined that the new Basel framework is only necessary for the world's largest banks, preserving the Basel I, defined structure for most American banking institutions, while granting the largest U.S.-based international banks the flexibility in capitalization provided by the vague risk-assessment approach of Basel II.<sup>55</sup>

### C. International Banking in China: Opening a New Market to the World

As part of its obligations for accession to the WTO, China began a limited opening of its banking sector to international competition in late 2006.<sup>56</sup> Historically, China has been able to shield itself from the international ebbs and flows of the global economy by using its citizens' high savings rate and the government-controlled banking sector to funnel money to state-owned enterprises ("SOEs") as well as town and village enterprises ("TVEs").<sup>57</sup> However, this massive savings rate is coupled with a potentially ineffective banking sector created by years of government control.<sup>58</sup> The business loans the government directed the banking sector to make, mostly to non-productive governmental or quasi-governmental enterprises, created vast assets tied up in "non-performing" loans that had the potential to bring the Chinese economy to its knees.<sup>59</sup> There is danger that as the market opens, exposing the banking sector to foreign competition, "foreign banks will dominate the Chinese capital market, grasp a significant share of domestic savings, and then fail to support inefficient SOEs after applying international loan standards."<sup>60</sup> Considering the unique potential weaknesses of many outstanding loans in China, analysts suggest that it might be necessary to increase the capital reserve requirements to nine or ten percent for Chinese banks.<sup>61</sup>



The Basel Committee's importance to the international banking market and the broad acceptance of its principles and supervisory policies effectively bind the world because the Basel II framework is customary international law, despite the fact that it does not consider its promulgations binding.

China has made strides through government action to remove non-performing loans from the banks' portfolios in order to strengthen the banking sector.<sup>62</sup> However, as Chinese banks implement the Basel Accords, critics suggest they may be in greater danger of failure due to the retained non-performing loans and the relatively low reserve requirements of Basel II.<sup>63</sup> As China opens to international banks, new entrants to the Chinese market will be at a competitive advantage without the underperforming or non-performing loans which have saddled the Chinese banking sector.<sup>64</sup>

### III. ANALYSIS

The Basel Committee's importance to the international banking market and the broad acceptance of its principles and supervisory policies effectively bind the world because the Basel II framework is customary international law, despite the fact that it does not consider its promulgations binding.<sup>65</sup> Banking laws and regulations are supposed to protect banks from unnecessary exposure to increased risk, protect nations from having to dip into general funds to bail out banks, and protect people from losing savings in the aftermath of a bank failure.<sup>66</sup> The Basel II regulations are inadequate because they fail to establish a capital reserve framework that effectively regulates the international banking market.<sup>67</sup> Without effective capitalization or a robust deposit insurance regime, the Basel framework poses significant threats as developing nations, such as China, join the global banking marketplace.<sup>68</sup>

#### A. The Basel Committee Creates Customary International Law Binding on the World

The Basel Committee has a greater responsibility to the world because it is binding on all nations as customary international law.<sup>69</sup> Any rule can be binding on every nation in the world when "it has been generally accepted as a rule of conduct."<sup>70</sup> Though the Basel Committee does not operate as a legislative body with formalized lawmaking power, it creates customary international law because most States act in concert with its rules and feel a perceived legal obligation or requirement to do so.<sup>71</sup> The Basel Committee claims that it "does not

possess any formal supranational supervisory authority, and its conclusions do not . . . have legal force.”<sup>72</sup> However, the Basel Committee’s economic expertise,<sup>73</sup> the international acceptance of its policies,<sup>74</sup> and the widespread affects of its decisions<sup>75</sup> have effectively created an international governing body in the area of international banking supervision.<sup>76</sup>

Recently, the Committee has taken action to increase transparency in the promulgation of its regulations by utilizing open processes based on domestic comment and rule-making procedures.<sup>77</sup> Although it says otherwise, the Basel Committee’s self-recognition of the important role it plays in the international regulatory framework and the increasing use of the Committee’s work by other international institutions underscore the Basel Committee as the primary creator of customary international law in this arena.<sup>78</sup>

Further, domestic banking agencies have found it necessary to appeal to the Basel Committee for change, showing the power and necessity of Basel promulgation.<sup>79</sup> For example, the leading government officials in the United States have recently urged the Basel Committee to reevaluate risk-assessments in the wake of the recent mortgage crisis.<sup>80</sup> Basel II is customary international law because the Committee’s work is promulgated worldwide, its principles are widely accepted and cast a broad regulatory effect.<sup>81</sup>

In addition to the traditional framework, customary international law begins with generalized statements of law derived from declarations by international organizations.<sup>82</sup> The International Court of Justice has found customary international law from statements by the United Nations General Assembly (“General Assembly”),<sup>83</sup> which is the world’s policy making body for most international political cooperation.<sup>84</sup> The Basel Committee’s influence in the arena of banking regulation at least equals, if not surpasses, the power that the General Assembly holds in the political arena.<sup>85</sup> If the world recognizes the General Assembly, a legislative body without sovereign force, as a promulgator of customary international law, the Basel Committee, having a similar or greater effect on the development of law in the banking field, also creates customary international law.<sup>86</sup>

### **B. Imposing Weakly-Supervised, Flexible Capital Reserve Requirements on Newly Deregulated Chinese Banks Leaves Internationally Active Banks Susceptible to Global Losses Stemming from a Savings Crisis**

As the world implements Basel II, the addition of an open Chinese banking market will affect the more relaxed Basel framework.<sup>87</sup> The new, flexible capital reserve requirements fail to sufficiently protect consumer deposits from bank failure.<sup>88</sup> Less stringent regulatory requirements fail to ensure that banks constitute investment portfolios that serve the societal interest of a stable banking system.<sup>89</sup> The new Basel II standards may

allow large, multinational corporate banks to enter new markets with a competitive advantage over smaller banks worldwide.<sup>90</sup> In turn, while giving large banks a competitive advantage, the Basel Committee does not require those banks to have sufficient capitalization requirements to cover consumer and corporate deposits.<sup>91</sup>

The eight percent capital reserve requirement, implemented by China as the market opens, poses grave dangers to an economy that is still working through the issues of non-performing loans directed by the state.

Instead, the Basel II framework states that banks “may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure.”<sup>92</sup> Effectively, this provision allows banks to choose whether to subject themselves to the transparent, predictable risk assessment system outlined in Basel I and continued in Basel II or to a less transparent system based on their own internal assessments.<sup>93</sup> While the capitalization requirement remains eight percent, the risk adjustments are more important to determining the amount of capital banks retain because the assets a bank must capitalize are discounted, determining the amount to which banks apply the eight percent standard.<sup>94</sup>

In China’s emerging banking environment, the Basel II framework poses unique challenges.<sup>95</sup> The eight percent capital reserve requirement, implemented by China as the market opens, poses grave dangers to an economy that is still working through the issues of non-performing loans directed by the state.<sup>96</sup> Further, as large banks move from the defined standard of capital to a more flexible risk-based standard, they gain an international advantage compared to new entrants into the international banking market—such as the Chinese banks; disadvantaged banks would then seek international business of their own in order to remain competitive in their home market.<sup>97</sup>

The recent problems in the U.S. mortgage market have put significant strain on the world banking sector.<sup>98</sup> Basel II frameworks contributed to the weakness by allowing banks to misstate the risk American sub-prime mortgages posed to their capital frameworks.<sup>99</sup> If the most sophisticated international banks were unable to accurately develop internal risk mechanisms to protect themselves from the collapsing U.S. mortgage market, it seems unlikely that Chinese banks and those of other developing economies will do better.<sup>100</sup>



### C. Basel Implementation and International Competition May Leave Chinese Banks at a Competitive Disadvantage Because the Chinese Government Require Banks to Make Non-Performing Loans

In addition to the problems Chinese banks will have in the global market, Basel II also poses problems for the domestic Chinese banking market.<sup>101</sup> In China, the savings rate has propped up the banking sector and the rest of its economy through the danger of questionable loan practices directed by the totalitarian regime.<sup>102</sup> This dramatically high savings rate allowed China to survive the Asian banking crisis and domestic banks to back the astonishing development of the Chinese economy.<sup>103</sup> As the Chinese economy becomes increasingly market-based, the transparency of its regulations becomes more important to the banking world.<sup>104</sup>

The opening of the Chinese market will lead to Western entrance into the mainstream Chinese market and to Chinese banks expanding their global interests into Western markets.<sup>105</sup> Basel II's requirement that banks maintain their own internal risk assessments fails to institute the necessary internationally cognizable transparency to ensure confidence in a global banking structure.<sup>106</sup>

The Basel II framework threatens the Chinese economy because instead of requiring sufficient capitalization standards, it leaves important calculations up to individual banks.<sup>107</sup> As customary international law, the failure of Basel II to sufficiently protect deposits in China threatens not only Chinese banks as they face competition from the large multinational banks in Western nations but also threatens Chinese banks as they enter a volatile market.<sup>108</sup> Large international banks subject to the more flexible internal ratings-based approach are now entering the Chinese market as a result of Chinese WTO commitments.<sup>109</sup> Further, and perhaps most importantly, Chinese banks presumably have internal risk assessments of their own that they must follow under a responsible business plan.<sup>110</sup> If an internal assessment finds risky investments prevalent within the bank, a capitalization requirement of nine or ten percent may be appropriate.<sup>111</sup> Internal assessments could theoretically prevent such a bank from

changing its capitalization requirements to what may be a more reckless standard of eight percent considering the unique perils present in the Chinese market.<sup>112</sup> If the internal assessments show that the bank needs to retain more capital to ensure bank strength, the Chinese banks are put at a severe disadvantage by the implementation of the Basel II accords.<sup>113</sup> This disadvantage is exacerbated by the ability of Western banks, eager to enter the Chinese market, to lower their capital reserve requirements under the new flexible standards.<sup>114</sup> However, the primary goal of the Basel Committee is to promote international banking stability, not to ensure that nations have strong domestic banking.<sup>115</sup>

While the integration of China into a global banking marketplace leads to the demolition of Chinese banks because of competitive disadvantages, those banks may also be less able to compete abroad.<sup>116</sup> Globally, depositors as investors will be less likely to back Chinese banks moving to compete in foreign markets without cognizable regulatory standards that all banks must maintain, especially if the Chinese banking sector is being overrun by Western banks.<sup>117</sup> The legally opaque Basel regulatory structure could hamper China's ability to integrate into the global banking system—leading to a banking crisis in China as domestic confidence in Western-dominated, but little understood, banks wanes.<sup>118</sup>

It is hard to imagine an integrated global banking system, or, in fact, any integrated global economic system, without Chinese banks being a large part of the continued development of Asia. However, the Basel Committee created a regulatory regime that could lead to confidence crises in the global markets caused by insufficient capitalization.<sup>119</sup> The inability of the Basel II framework to require banks to sufficiently capitalize the risks associated with American home loans has caused some of the current uncertainty in the global economy.<sup>120</sup> Basel II's drawbacks exposed by the U.S. mortgage crisis fail to inspire confidence in its ability to effectively regulate the international market as it diversifies to include the unique Chinese market and other developing nations.<sup>121</sup>

## IV. RECOMMENDATIONS

As the worldwide banking regulator, the Basel Committee occupies an important part of the worldwide governance structure.<sup>122</sup> As it continues to meet, the Basel Committee must recognize its role as a promulgator of customary international law.<sup>123</sup> The Basel Committee should also consider implementation of a regulatory regime relying on a centrally defined capitalization framework which mirrors actual risk exposure.<sup>124</sup> Further, the Committee should consider implementation of a global requirement of deposit insurance.<sup>125</sup> As the Basel Committee moves to the future, it must ensure that their regulations serve the entire banking community with the flexibility to benefit large and small international actors from both the developed and developing world.<sup>126</sup>

### **A. The Basel Committee Should Recognize Its Role as Global Banking Regulators, Promulgating Legal Standards, Not Just Recommendations**

First, as the Committee moves forward, it must balance the need for a strong international regulatory regime against domestic trepidation towards relinquishing sovereignty over the banking industry.<sup>127</sup> As the international expert on banking regulation, the Basel Committee is effectively promulgating international law.<sup>128</sup> While the political costs of overt recognition may be high, the Basel Committee should admit to its power and influence on the world banking system.<sup>129</sup> Specifically, instead of beginning its documentary Framework by distancing itself from regulatory authority,<sup>130</sup> the Basel Committee should openly declare its role as promulgator of customary international law at the beginning of its regulations.<sup>131</sup> By removing the modesty from its promulgations, the Basel Committee can truly position itself as an internationally recognized regulatory agency with the ability to ensure necessary consumer confidence in the global banking system.<sup>132</sup>

### **B. The Basel Committee Should Work to Improve Transparency in Capitalization Standards, but Retain the Flexibility of Risk Assessments Offered to the System.**

In considering an update to Basel II, the Basel Committee should allow sophisticated international banks to retain the flexibility of Basel II while granting smaller banks the competitive advantages Basel II affords larger banks.<sup>133</sup> Such a framework could simultaneously require banks in developing nations, such as China, to retain more capital if their loan portfolio experiences increased risk.<sup>134</sup> The Basel Committee should promulgate regulations that ensure a robust eight percent capital reserve requirement, as it has in the past, but it should also institute a framework to determine a transparent and flexible sliding scale of asset risk assessments.<sup>135</sup> These additions would allow banks, regardless of size, to compete and grow on a level playing field, would protect developing nations which may have bad loan problems, and would allow the world governing system to participate in the changing risk factors evaluated on a global scale.

### **C. The Committee Should Require International Deposit Insurance to Promote Confidence in the Banking Market.**

Finally, the Committee should require a strong deposit insurance structure in order to protect consumers.<sup>136</sup> The Basel Committee was founded to foster increased cooperation in a more global economy.<sup>137</sup> As the developing world continues to integrate with the global banking sector, the lack of worldwide required deposit insurance will become more problematic.<sup>138</sup>

Globally mandated deposit insurance will create internationally recognizable trust in the consumer banking market.<sup>139</sup> The community of internationally active banks is growing to serve emerging markets, infiltrating further into the day-to-day consumer banking sector, and incorporating more banks

from economically diverse nations.<sup>140</sup> Internationally guaranteed consumer confidence based on insured deposits will protect the system from bank runs and promote an internationally consistent market based on mutually protected deposits.<sup>141</sup>

Deposit insurance need not be implemented in the same way everywhere.<sup>142</sup> The Basel Committee should consider a scheme which protects sufficient consumer deposits in every nation, based on the economic circumstances of that nation.<sup>143</sup> Nations with greater median incomes, higher standards of living, and better distribution of wealth like the industrialized Western world will understandably need deposits insured to a higher threshold.<sup>144</sup> The developing world and the undeveloped world may find it expensive, inappropriate, and unnecessary to insure deposits up to the comparatively high levels found in the developed world.<sup>145</sup> Essentially, the Basel Committee should either require national regulatory agencies to create a minimum framework of deposit insurance or the Committee should create an international system of deposit insurance. In either case, the Committee should require differing levels of insurance coverage in different nations based on internationally recognized economic indicators.<sup>146</sup>

In considering an update to Basel II, the Basel Committee should allow sophisticated international banks to retain the flexibility of Basel II while granting smaller banks the competitive advantages Basel II affords larger banks.

## **V. CONCLUSION**

The Basel Committee is the international promulgator of international banking regulation because the Basel II framework is customary international law. As Chinese banks enter the world market, and internationally active banks begin to enter the Chinese market, the Basel Committee's capital standards must remain strong to withstand the unique pressures of the increasingly eastern global banking sector. In addition to strengthened capital standards, the Committee's failure to ensure robust deposit insurance worldwide further under-serves the unique challenges of the Chinese market. As the worldwide banking regulator, the Basel Committee should ensure that capitalization standards for internationally active banks are robust and consumer deposits worldwide are insured against bank failures from both familiar and unfamiliar market participants. The banking world has steamrolled over the banking structures created after World War II, and Basel must continue to promote rigidity and work to stabilize the banking sector to avoid the pitfalls of the last century. **BLB**

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- <sup>1</sup> See BASEL COMM. ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, HISTORY OF THE BASEL COMMITTEE AND ITS MEMBERSHIP 1 (2007), <http://www.bis.org/bcbs/history.pdf> [hereinafter Basel History] (stating that since its creation in 1974 the Basel Committee has created broad standards and guidelines as frameworks for individual banking authorities to use in creating systems of bank regulation and supervision suited for their home country's banking sector).
- <sup>2</sup> See W. Ronald Gard, *George Bailey in the Twenty-First Century: Are We Moving to the Postmodern Era in International Financial Regulation with Basel II?*, 8 TRANSACTIONS: THE TENN. J. OF BUS. L. 161, 162 (2006) (declaring that the Basel promulgations have not been passed by any legislatures but are effectively implemented worldwide).
- <sup>3</sup> See L. Jacabo Rodriguez, *International Banking Regulation: Where's the Market Discipline in Basel II?*, 455 POL'Y ANALYSIS 1, 1-2 (2002), available at <http://www.cato.org/pubs/pas/pa455.pdf> (describing the widespread implementation of the Basel I regulations and the unilateral acceptance of the Basel Committee).
- <sup>4</sup> See Weitseng Chen, *WTO: Time's Up for Chinese Banks—China's Banking Reform and Non-Performing Loan Disposal*, 7 CHI. J. INT'L L. 239, 239 (2006) (citing Francesco Guerrera & Richard McGregor, *Goldman Leads Trio Taking a \$3.8bn Stake in Chinese Bank*, FIN. TIMES, Jan. 27, 2006, at 21; Justine Lau & Geoff Dyer, *Citigroup Eyes China after Ending Exclusive Bank Link*, FIN. TIMES, Dec. 27, 2005, at 15; John Ridding, *Long Wait Gives Way to a Burst of Reform Traffic*, FIN. TIMES, Nov 8, 2005, at 4) (describing the intense Western financial anticipation for an opening of the Chinese banking market to investment and competition); see also Karen Halverson, *China's WTO Accession: Economic, Legal and Political Implications*, 27 B.C. INT'L & COMP. L. REV. 319, 333 (2004) (discussing China's accession to the World Trade Organization as an impetus for reform and openness to western investment).
- <sup>5</sup> See, e.g., Gard, *supra* note 2, at 165-75 (chronicling the emergence of the modern banking system from the ashes of World War II, through the various banking challenges presented during the Cold War, to the present establishment of the Basel Committee as the standard-bearer for international banking regulation).
- <sup>6</sup> See Duncan E. Alford, *Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?*, 28 B.C. INT'L & COMP. L. REV. 237, 295 (2005) (discussing the emergence of China and other developing markets in the banking sector and the necessity that the Basel Committee incorporate developing nations into bank regulation procedures and processes).
- <sup>7</sup> See Gard, *supra* note 2, at 197-98 (contending that the Basel II regime reflects a new worldwide regulatory system which will create the framework for the future of the international banking market). The Basel II system creates an alternative to the Basel I regulations, attempting to create a framework where the world largest banks can operate under a new, "complex, convoluted, individualized system . . . reflect[ing] our world today, wherein one agreement to fit the problem is no longer recognized as a viable goal." *Id.* See also discussion *infra* Part III.A (arguing that the Basel Committee has occupied the field of international banking regulation and is binding as customary international law).
- <sup>8</sup> See generally BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK-COMPREHENSIVE VERSION (2006), available at <http://www.bis.org/publ/bcbs128.pdf> [hereinafter Basel II] (enumerating a comprehensive framework for regulating the capital standards required from internationally active banks).
- <sup>9</sup> See *id.* at 1 (asserting that Basel II has been "endorsed by the Central Bank Governors and Heads of Banking Supervision of the Group of Ten countries"). The major banking nations promulgated the Basel II framework to "strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks." *Id.* at 2.
- <sup>10</sup> See discussion *infra* Part II.A.
- <sup>11</sup> See discussion *infra* Part II.B.
- <sup>12</sup> See discussion *infra* Part II.C.
- <sup>13</sup> See discussion *infra* Part III.A.
- <sup>14</sup> See discussion *infra* Part III.B.
- <sup>15</sup> See discussion *infra* Part III.C.
- <sup>16</sup> See discussion *infra* Part IV.
- <sup>17</sup> See discussion *infra* Part V.
- <sup>18</sup> See, e.g., Herbert V. Morais, *The Quest for International Standards: Global Governance v. Sovereignty*, 50 KAN. L. REV. 779, 785 (2002) (describing the growth of international convergence in the banking sector, especially in regulations pertaining to terrorism financing and money laundering); see also Gard, *supra* note 2, at 165-78 (chronicling the international banking market from the post-World War II Bretton-Woods creations to the Basel Committee's integration of central bankers); Heath Price Tarbert, Comment, *Rethinking Capital Adequacy: The Basle Accord and the New Framework*, 56 BUS. LAW. 767, 769-70 (2000-2001) (asserting the importance of the creation of an "efficient banking system" to the industrialized world and the significance of globalization as a trend in the banking business).
- <sup>19</sup> See Walter I. Conroy, Note, *Risk-Based Capital Adequacy Guidelines: A Sound Regulatory Policy or a Symptom of Regulatory Inadequacy?*, 63 FORDHAM L. REV. 2395, 2397-99 (1995) (defining the importance of capital reserve regulations as the banking industry continues to globalize and grow increasingly complicated in its asset portfolio).
- <sup>20</sup> See Chen, *supra* note 5, at 240-42 (enumerating the unique features of the Chinese market which made it able to withstand the Asian financial crisis, the market features which make the market attractive to incoming international banks, and those which pose dangers and pitfalls as the world market engulfs the Chinese banking market).
- <sup>21</sup> Tarbert, *supra* note 18, at 767 (describing the basic framework of the banking system and defining a bank as a "business establishment authorized to perform financial transactions, such as receiving or lending money" (quoting AMERICAN HERITAGE DICTIONARY 67 (3d ed. 1994))).
- <sup>22</sup> Tarbert, *supra* note 18, at 767 (citing ROBERT F. MEIGS & WALTER B. MEIGS, ACCOUNTING: THE BASIS FOR BUSINESS DECISIONS 20 (9th ed. 1993)).
- <sup>23</sup> Tarbert, *supra* note 18, at 771 (explaining that the basic banking income statement is Capital = Assets (loans) – Liabilities (deposits)). The retained capital has to be enough to ensure that a retail bank can pay the deposits that will be demanded at any one time. Statement of the Shadow Financial Regulatory Committee Meeting, American Enterprise Institute, Mar. 2, 2000, [http://www.aei.org/publications/pubID.16542.filter.all/pub\\_detail.asp](http://www.aei.org/publications/pubID.16542.filter.all/pub_detail.asp); see also Tarbert, *supra* note 18, at 770-72.
- <sup>24</sup> RONALD MACDONALD, DEPOSIT INSURANCE 9 (Centre for Central Banking Studies, Bank of England, 1996), available at <http://www.bankofengland.co.uk/education/ccbs/handbooks/pdf/ccbshb09.pdf> (outlining the importance of deposit insurance to the protection of capitalization schemes and the stability of the world banking market); see also Conroy, *supra* note 19, at 2397-98 (explaining the importance of capitalization in banks to ensure that banks can meet their obligations and highlighting the central role that deposit insurance plays in stabilizing domestic banking markets).
- <sup>25</sup> See, e.g., Maurice L. Shevin, *The Poverty Industry—Pro Consumer Finance—The Fuel that Drives the Economy*, 58 ALA. LAW. 230, 230 (1997) (describing the wide range of services, such as credit cards and mortgages, that financial institutions provide to the general public, which permeate the culture of most developed countries).
- <sup>26</sup> See, e.g., FDIC, Mission, Vision and Values, <http://www.fdic.gov/about/mission/index.html> (last visited Apr. 24, 2008) [hereinafter FDIC Mission] ("The Federal Deposit Insurance Corporation (FDIC) is an independent agency created by the Congress that maintains the stability and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions, and managing receiverships.").
- <sup>27</sup> See, e.g., *id.*; Financial Services Compensation Scheme, Consumer Home Page, [www.fscs.org.uk/consumer/](http://www.fscs.org.uk/consumer/) (last visited Apr. 24, 2008) [hereinafter U.K. Deposit Insurance Overview] (asserting that the Financial Services Compensation Scheme is "the [United Kingdom]'s compensation fund of last resort for customers of financial services firms"); CDIC, Who We are and What We Do, [http://www.cdic.ca/index.cfm/ci\\_id/1218/la\\_id/1.htm](http://www.cdic.ca/index.cfm/ci_id/1218/la_id/1.htm) (last visited Apr. 24, 2008) [hereinafter CDIC Overview] ("CDIC insures Canadians savings in case their bank or other CDIC member institution fails or goes bankrupt.").
- <sup>28</sup> See MACDONALD, *supra* note 24, at 8 (establishing that over ninety nations, spread over North and South America, Europe, Africa, Asia and Australia have either formal deposit insurance or implicit deposit protection).

<sup>29</sup> See JOHN H. BOYD, PEDRO GOMIS, SUNGKYU KWAK & BRUCE SMITH, A USERS GUIDE TO BANKING CRISES 10 (World Bank, 2000), available at [http://siteresources.worldbank.org/INTFR/Resources/475459-1108066643741/boyd\\_smith.pdf](http://siteresources.worldbank.org/INTFR/Resources/475459-1108066643741/boyd_smith.pdf) (declaring that virtually all economies impose reserve requirements on banks, which can have a stabilizing force on inflation).

<sup>30</sup> See MACDONALD, *supra* note 24, at 9 (describing the “moral hazard” that deposit insurance creates by “freeing economic actors from the consequences of their actions”). The “moral hazard” associated with deposit insurance arises because depositors, now insured from loss by their government, have no obligation to assess the credit risk of the banks they are using for savings. *Id.* Thus, owners and managers of the bank may take risks without market forces discouraging the action. See V. Gerard Comizio, *The Role of Deposit Insurance: Financial System Stability and Moral Hazard*, in 4 CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS 416-17 (Robert C. Effros ed. 1997) (chronicling the savings and loan crisis of the 1980s as an example of the moral hazard of government-insured deposits coupled with lackadaisical regulation). These risks have potentially serious adverse consequences for the governments that are providing the insurance, and, indirectly, to the taxpayers who are supporting those governments. MacDon-ald, *supra* note 24, at 9. Governments have erected complex regulatory schemes to protect the public from the moral hazard of bankers investing insured assets in overly risky enterprises. *Id.*

<sup>31</sup> See MACDONALD, *supra* note 24, at 10 (outlining the basic premise of pay-ment under a deposit insurance scheme).

<sup>32</sup> *Id.* at 9 (describing the lack of market incentives for banks to mitigate risk when the government insures them against their liabilities and fails to adequately regulate their capitalization standards); see also ROBERT CULL, LEMMA W. SENBET & MARCO SORGE, DEPOSIT INSURANCE AND FINANCIAL DEVELOPMENT 13-14 (World Bank 2000) available at [http://siteresources.worldbank.org/INTFR/Resources/475459-1108066643741/cull\\_senbet.pdf](http://siteresources.worldbank.org/INTFR/Resources/475459-1108066643741/cull_senbet.pdf) (pronouncing that when deposits are insured depositors face no risk and the risk of bank failure due to risky investment transfers to the deposit insurer, usually the government).

<sup>33</sup> See Tarbert, *supra* note 18, at 775 (explaining that government regulation of capital can guard against runs by depositors fearful of bank failure, reduce the risk of systemic bank failures triggered by the failure of any one bank, prevent a taxpayer bailout of failed banks, and diminish the competition to over-leverage assets).

<sup>34</sup> David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. J. INT’L L. 547, 555 (2004–2005) (describing the impetus for central bank governors to create the Basel Committee on Banking Supervision, prompted by large, international bank failures in 1974 (such as the Herstatt failure)); see also, Gard, *supra* note 2, at 176 (illustrating the need to “coordinate and establish regula-tory conditions among banks” after the financial challenges of the Herstatt debacle).

<sup>35</sup> See Gard, *supra* note 2, at 174-75 (explaining that nations had used pruden-tial regulations seeking to minimize the social costs of bank failures, and that the creation of international standards through the Basel Committee “builds confidence in both domestic and foreign banks, and provides stability from bank failure” and allows for the smaller banks to continue to compete in an increasingly global banking market); see also Tarbert, *supra* note 18, at 776-77 (describing the shortcomings with United States Federal Reserve regulations in a market where foreign institutions, not subject to American regulation, hold many American deposits; and, discussing the global systemic risk which would affect the U.S. market, regardless of nationality of a failed bank).

<sup>36</sup> See Tarbert, *supra* note 19, at 779 (describing the Basel Committee as composed of the Group of 10 nations which meet at the Bank for International Settlements in Basel, Switzerland); see also BASEL COMM. ON BANKING SUPER-VISION, BANK FOR INTERNATIONAL SETTLEMENTS, PRINCIPLES FOR THE SUPER-VISION OF BANKS’ FOREIGN ESTABLISHMENTS 1 (1983), <http://www.bis.org/publ/bcbcs312.pdf> [hereinafter BASEL CONCORDAT] (promulgating the basic principles of the Basel Committee as allocating responsibilities between parent and host supervisory authorities and ensuring cooperation between them); Basel Com-mittee on Banking Supervision, Bank For International Settlements, About the Basel Committee, <http://www.bis.org/bcbcs/index.htm> (last visited Apr. 24, 2008) [hereinafter About Basel] (describing the Basel Committee’s purpose to foster communication between banking authorities).

<sup>37</sup> See BASEL HISTORY, *supra* note 1, at 1 (illustrating that the Basel Committee regulates by authority gleaned from the central bankers that are members); see also BASEL II, *supra* note 9, at 1 (declaring that the agreement is automatically binding on members who helped write it). National governments have delegated regulatory authority to the central bankers, who, in turn, meet with their international counterparts to determine international standards; central bankers can then implement those standards without legislative approval in their respective nations. Tarbert, *supra* note 18, at 779-80.

<sup>38</sup> See About Basel, *supra* note 36 (describing the goals and responsibilities of the Basel Committee for Banking Supervision in a growing and expanding interna-tional banking market).

<sup>39</sup> See Alford, *supra* note 7, at 240-42 (chronicling the evolution of the interna-tional banking system as it developed from rebuilding mid-century Europe to the increasingly global system of regulations and interconnected markets which Basel attempts to organize and regulate).

<sup>40</sup> See Anshu S. K. Pasricha, Comment, *On Financial Sector Reform in Emerging Markets: Enhancing Creditors’ Rights and Securitizing Non-Performing Loans in the Indian Banking Sector—An Elephant’s Tale*, 55 BUFF. L. REV. 325, 328-29 (2007) (illustrating the effect of the Asian banking crisis on the economic and banking policies in India and China, and the importance of those emerging markets as the global banking system develops).

<sup>41</sup> See Gard, *supra* note 2, at 166-68 (describing the rise of the Bretton-Woods international monetary system after WWII when America was established as the world currency stabilizer, the dollar was tied to gold and the rest of the world cur-rency was tied to the dollar, bringing further stability).

<sup>42</sup> Gard, *supra* note 2, at 168-70 (describing the surprisingly rapid decline of the U.S. dollar’s ability to serve as the international monetary standard as the supply of dollars threatened to exceed the U.S. gold supply).

<sup>43</sup> *Id.* at 169 (citing MICHAEL MOFFITT, THE WORLD’S MONEY: INTERNATIONAL BANKING FROM BRETTON WOODS TO THE BRINK OF INSOLVENCY 46-48, 66, 74-75, 77 (1983)); see also George H. Windecker, Jr., Comment, *The Eurodol-lar Deposit Market: Strategies for Regulation*, 9 AM. U. J. INT’L L. & POL’Y 357, 362-64 (1994) (chronicling the rapid growth of a Eurodollar market after World War II and outlining the holes it exposed in the global financial system).

<sup>44</sup> See Gard, *supra* note 2, at 169-70 (describing the instability created in the international banking market when currency was both traded on the global mar-ket, and simultaneously tied to gold, or to the U.S. dollar).

<sup>45</sup> See *id.* 178-79 (describing the importance of Basel I to the international bank-ing system). See generally BASEL COMM. ON BANKING SUPERVISION, BASEL CAPITAL ACCORD, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988), <http://www.bis.org/publ/bcbcs111.pdf> [hereinafter Basel I] (establishing a global framework of capitalization standards for the first time).

<sup>46</sup> BASEL I, *supra* note 45, at 13, 17-18 (enumerating the five categories of bank assets based on risk and allowing banks to reduce their capital retention in cases where they have invested in safer assets, while requiring sufficient capital reserves where banks have invested in somewhat riskier assets). See also Tarbert, *supra* note 18, at 785 (describing Basel I’s goal of “universal adoption of a rule requiring a fixed percentage of capital, even when apportioned to assets on the basis of risk” in order to provide greater stability in the global banking sector).

<sup>47</sup> See BASEL I, *supra* note 45, at 17-18 (establishing the rates at which certain, safer assets can be discounted). For example, residential mortgages can be discounted fifty per-cent before the capitalization requirement of eight percent is imposed. *Id.* So, if a bank holds a mortgage of \$1 million, they can discount that to \$500,000, thus only requiring them to retain \$40,000 of capital under the Basel I regulations. If it were not allowed to discount the mortgage, the bank would be required to retain \$80,000 of capital.

<sup>48</sup> PETER COOK, BANK CAPITAL ADEQUACY AND CAPITAL CONVERGENCES 6 (1991). The framework defines assets based on their credit risk. Basel I, *supra* note 45, at 8. For example, a residential mortgage is considered moderately risky, and given a risk factor of fifty percent. *Id.* at 11. Effectively, if a bank takes in \$1000 of deposits, and the only loans it is going to make are residential mortgage loans, it must capitalize \$40 and may loan out \$960. See generally *id.*

<sup>49</sup> See Tarbert, *supra* note 18, at 786 (citing 12 C.F.R. § 208 app. A, attachment II (2000)).

<sup>50</sup> See BASEL I, *supra* note 45, at 14 (defining the five kinds of Tier 2 capital, as compared to the two strictly defined types of Tier 1 capital).

<sup>51</sup> See Gard, *supra* note 2, at 189 (illustrating the introduction of the internal-bank-ratings-based approachs (IRBs) in the Basel II accord to take advantage of the extensive risk management calculations that major international banks use in their loan origination processes).

<sup>52</sup> See BASEL I, *supra* note 45, at 17-18 (enumerating the five categories of assets that determined the risk-based rate at which those assets were categorized); see also Gard, *supra* note 2, at 187-88 (comparing the rigid definitional system of Basel I with the more fluid system of Basel II).

<sup>53</sup> See generally BASEL II, *supra* note 9 (enumerating the market risk provisions of the BASEL II banking regulations and allowing the use of internal risk assessment procedures by banks to calculate the necessary retained capital to protect consumers from bank failures).

<sup>54</sup> See HAL S. SCOTT & PHILIP A. WELLONS, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION* 245 (6th ed. 1999) (describing the benefits of having sophisticated, internationally active banks use a “credit risk” approach by incorporating models “designed to predict the probability of default and the likely recovery of assets after a default”).

<sup>55</sup> See Gard, *supra* note 2, at 186-88, 192 (describing the implementation of Basel II by the United States Federal Reserve Board as a two-tiered system: 1) the stricter, more formulaic and defined capitalization requirements contained in Basel I and in Pillar I of Basel II for most financial institutions; and 2) a flexible approach based on modern risk management approaches for the nation’s largest, most complex financial institutions).

<sup>56</sup> See Chen, *supra* note 5, at 261 (asserting that China used WTO accession as a deadline for instituting banking reforms to bolster domestic banks before exposing them to international competition).

<sup>57</sup> See *id.* at 240-42 (showing that the savings rate in China is the world’s highest at around forty percent). This immense savings rate, and the tradition that the Chinese government has instilled in the Chinese people of promoting frugality and large savings rates in the population also serves as an immense potential source of operating capital for internationally active banks as they begin to enter the Chinese market. *Id.*

<sup>58</sup> *Id.* at 240-43 (listing the damage which Chinese Communist government control over the banking sector, the insistence on banks to invest in party priorities, and the plethora of non-performing loans has had on the Chinese banking system).

<sup>59</sup> *Id.* at 242-43. In preparation for opening its markets, the Chinese government has taken steps to remove non-performing loans from the banking sector. *Id.* at 250. It has attempted to ease the economic transition by disposing bad loans from the banking sector. *Id.* In doing so, it has attempted to maintain market incentives for SOEs with available assets to repay their loans. *Id.* They have done so using Asset Management Companies and government recapitalization of Chinese state-owned banks prior to their exposure to the global market at WTO accession according to the General Agreement on Trade in Services (GATS). *Id.* at 251.

<sup>60</sup> *Id.* at 249-50. As of 2005, the Chinese authorities were considering restricting the ability of foreign banks from competing against domestic banks in spite of its WTO commitments, logically concerned about the effect foreign control of national savings, and in turn Chinese capital, would have on the Communist regime’s ability to retain control over SOEs. Richard McGregor, *Beijing May Look to Protect Local Banks from Competition*, *FIN. TIMES* 13 (Apr. 28, 2005).

<sup>61</sup> Jonathan Tarn & Tim LeeMaster, *Minsheng in 6B Yuan Bond Sale*, *THE STANDARD*, Aug. 10, 2004.

<sup>62</sup> See Chen, *supra* note 5, at 250-52 (observing the reforms China has made, beginning in the 1990s, to attempt to rectify the problems in the domestic economy caused by non-performing loans).

<sup>63</sup> See Eric Y. Wu, *Developments in Banking and Financial Law 2004:VII. International Developments: A. Basel II: A Revised Framework*, 24 *ANN. REV. BANKING & FIN. L.* 150, 158-59 (2005) (asserting that some Chinese banks are concerned with the implementation of a flexible eight percent capital reserve requirement and believe that the system may require a nine or ten percent reserve requirement in order for the Chinese banking market to function effectively); David Finn, *Peering Over the Great Wall: Extraterritorial Securities Regulation and U.S. Investment in China’s State-Owned Banks*, 7 *U.C. DAVIS BUS. L.J.* 277, 289 (2006) (indicating “bad loans, a lack of transparency, and significant corruption” as significant problems associated with government control of the Chinese banking sector). But see Hui Cao, *Asset Securitization: Is it a Resolution Option for China’s Non-Performing Loans?*, 28 *BROOKLYN J. INT’L L.* 565, 571 (2003) (estimating that non-performing loans tie up anywhere from ten to forty percent of all banking assets).

<sup>64</sup> See Cao, *supra* note 63, at 571-72 (detailing the direct, and more recently indirect, influence the central government played in directing loans made by Chinese banks before the recent efforts at banking sector reform).

<sup>65</sup> See, Basel II, *supra* note 9, at 1 (“This document is being circulated to supervisory authorities worldwide with a view to encouraging them to consider adopting this revised Framework at such time as they believe is consistent with their broader supervisory priorities.”). See also About Basel, *supra* note 36 (asserting only that the Basel Committee provides a forum for discussion of key supervisory principles, not that the forum holds any legislative or regulatory power over its member nations or the world).

<sup>66</sup> See, e.g., The Glass-Steagall Act, 48 Stat. 182 (1933) (creating the Federal Deposit Insurance Corporation in the United States “[t]o provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations . . .”); FDIC Mission, *supra* note 26 (asserting that the purpose of the FDIC is to “maintain[] the stability and public confidence in the nation’s financial system by insuring deposits, examining and supervising financial institutions, and managing receiverships”).

<sup>67</sup> See generally BASEL II, *supra* note 9.

<sup>68</sup> See generally *id.* (failing to require deposit insurance on a global scale).

<sup>69</sup> Cf. United Nations General Assembly, Functions and Powers of the General Assembly, <http://www.un.org/ga/about/background.shtml> (last visited Apr. 24, 2008) [hereinafter General Assembly Powers] (asserting only that the General Assembly makes “non-binding recommendations to States on international issues within its competence”).

<sup>70</sup> The *Scotia*, 81 U.S. 170, 187 (1876); see The *Paquete Habana*, 175 U.S. 677, 700 (1900) (“[W]here there is no treaty, and no controlling executive or legislative act or judicial decision, resort must be had to the customs and usages of civilized nations.”). International customary law is not only essential in the United States to decide the law of admiralty; the International Court of Justice (ICJ) considers it applicable law to settle disputes. ICJ art. 38(1)(b). Customary law further permeates the international framework not only by United Nations acceptance through the ICJ charter, but also the Vienna Convention on the Law of Treaties has recognized that some customary law, *ius cogens*, supersedes all treaty law, even treaties enacted after international recognition of the custom. Vienna Convention on the Law of Treaties art. 53, May 23, 1969, 1155 U.N.T.S. 331.

<sup>71</sup> See Jack A. Goldsmith & Eric A. Posner, *A Theory of Customary International Law*, 66 *U. CHI. L. REV.* 1113, 1116 (1999) (defining customary international law as “the collection of international behavioral regularities that nations over time come to view as binding as a matter of law”); DAVID HUNTER, JAMES SALZMAN & DURWOOD ZAELEKE, *INTERNATIONAL ENVIRONMENTAL LAW AND POLICY* 313 (3d ed. 2007) (citing ICJ Art. 38(1)(b)) (discussing the creation of customary international law and its importance to environmental regulatory law). International environmental law’s inability to create a framework to avert catastrophic climate change is in many ways similar to the political realities in creating an international framework to regulate banking law. Compare Hunter, *supra* note 71, at 313 (describing the importance of customary law in promulgating international environmental standards), with Gard, *supra* note 2, at 162 (“[N]o national legislatures voted to approve Basel I.”). In the environmental arena, competing interests between the developed and developing world, along with concerns over outsourcing sovereignty to a global regime, have left the world without a global carbon regulatory regime. See Hunter, *supra* note 71, at 313. In the banking arena, similar interests have floundered in the creation of a robust, sovereign international banking regime. See Gard, *supra* note 2, at 175-79 (describing the competing political interests which led to the Basel system of unspoken legitimate authority over virtually all international banking regulation); Alford, *supra* note 7, at 242-45 (describing the political tradeoffs that led to the creation of the Basel Committee).

<sup>72</sup> Zaring, *supra* note 34, at 558 (enunciating the efforts of the Basel committee to downplay the legal force and importance of their supervisory documents despite global acceptance).

<sup>73</sup> See Fact Sheet – Basel Committee on Banking Supervision, <http://www.bis.org/about/factbcbcs.htm> (last visited Apr. 9, 2008) (enumerating the membership of the Basel Committee, listing the institutional supervisory authorities of thirteen major world banking nations as members of the Basel Committee). The institutional banking expertise of the Basel Committee is unparalleled in any other international organization in the world. See Tarbert, *supra* note 18, at 779 (evaluating the makeup of the Basel Committee and its influence).

<sup>74</sup> See Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 *EUR. J. INT’L L.* 15, 17 (2006) (emphasizing the reach of the Basel framework and the widespread acceptance of the provisions because the IMF, the World Bank and the market have pressured many, if not most, developing nations to institute the standards).

<sup>75</sup> See Zaring, *supra* note 34, at 560 (observing the “real impact” of the “widespread implementation” of the Basel pronouncements); see also Wu, *supra* note 63, at 155-60 (noting the affects which Basel II will have on the United States, the European Union, Australia, India, Latin America, the Pacific Rim, Africa and Islamic Banking Jurisdictions).

<sup>76</sup> Cf. Anthea Elizabeth Roberts, *Traditional and Modern Approaches to Customary International Law: A Reconciliation*, 95 *AM. J. INT’L L.* 757, 758 (2001) (recognizing the General Assembly as the primary creator of international customary law); but see BASEL II, *supra* note 9, at 1 (adopting the position that Basel II has no legal force, but is simply a working paper from a group of central bankers getting together to suggest guidelines for national regulatory regimes to implement).

<sup>77</sup> See Barr, *supra* note 74, at 17 (touting the rule-making process of the Basel Committee and the integration of domestic democratic rule-making procedures with the creation of international standards). Though the Basel committee began as a closed club of central bankers “discussing” common issues affecting the world banking system, “the Basel Committee has recently engaged in a relatively open process akin to a notice and comment rule-making in developing international capital standards, and has improved its transparency” *Id.*; see also BASEL COMM. ON BANKING SUPERVISION, *BANK OF INTERNATIONAL SETTLEMENTS, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 1* (1997), <http://www.bis.org/publ/bcbcs30a.pdf> [hereinafter BASEL CORE PRINCIPLES] (listing sixteen nations outside the G-10 nations who worked on the Committee’s core principles); Zaring, *supra* note 34, at 556 (noting the increasing practice of the Basel Committee to open their processes to comment periods and to outline rough schedules of further action by press release).

- <sup>78</sup> See Barr, *supra* note 74, at 41 (recognizing that the Basel accords are the global standard because international policies and market practices effectively made adoption necessary worldwide). The World Bank and International Monetary Fund (IMF) have used Basel adherence as part of their evaluation of individual nations. *Id.*
- <sup>79</sup> See, e.g., *The Semiannual Monetary Policy Report to Congress Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2008) (statement of Ben Bernanke, Chairman of the Federal Reserve Bank of the United States) (responding to Senator Reed's question regarding the weaknesses of Basel II's change in risk rated asset evaluation as compared to Basel I by stating that "this is certainly one of the areas where the Basel committee, in reviewing the lessons of the recent event, is looking carefully on how or whether to use credit ratings in the risk-measurement process"); see also Clay Lowery, Assistant Secretary for International Affairs, United States Department of Treasury, Remarks at the Annual Conference of the Institute of International Bankers (Mar. 3, 2008) available at <http://www.ustreas.gov/press/releases/hp855.htm> (recommending that the Basel Committee "assess the need for changes to the Basel II capital framework" considering the weakness in the banking sector that has been shown by the recent mortgage crisis in the United States, and the effect that crisis has had on the world).
- <sup>80</sup> See *supra* Sources cited in note 79.
- <sup>81</sup> See Hunter, *supra* note 71, at 313 (defining customary international law); Barr, *supra* note 74, at 17 (describing the actions and affects the Basel Committees actions have on the world banking structure).
- <sup>82</sup> See Roberts, *supra* note 76, at 758 (discussing the new approach to customary international law as a creation of law from expert organizations, primarily from the United Nations General Assembly, which is the primary political entity to recognize activity as customary).
- <sup>83</sup> *Id.* at 759 (describing the use of U.N. statements as a source of customary law so long as "instances of inconsistent practice had been treated as breaches of the rule concerned rather than as generating a new rule").
- <sup>84</sup> General Assembly Powers, *supra* note 69 (describing the General Assembly as "the chief deliberative, policy-making and representative organ of the United Nations. . . ." and enumerating the full scope of limitations on the Assembly's authority).
- <sup>85</sup> Compare *id.* (recognizing that General Assembly resolutions are not binding on members), with Basel II, *supra* note 9, at 1 (declaring that the Basel Committee only makes recommendations for the world banking regulators to implement).
- <sup>86</sup> See Gard, *supra* note 2, at 162 (inferring that from the widespread incorporation of Basel I the Committee has positioned itself as the prominent world bank regulator, and national agencies effectively implement the supranational authority).
- <sup>87</sup> See Wu, *supra* note 63, at 159 (describing the differing capital standards which may be necessary for Chinese banks to fully benefit from Basel II); cf. Halverson, *supra* note 5, at 342 (discussing the failure of Communist Hungary, Poland and Romania's accession to the General Agreement on Trade and Tariffs in the 1960s and 1970s in integrating the world trading system and the steps which the WTO took to ensure that China's accession affords full participation in the "international market system").
- <sup>88</sup> See generally Basel II, *supra* note 9. The Basel framework loosens capitalization requirements, and does not mandate deposit insurance worldwide. *Id.*
- <sup>89</sup> See, e.g., Comizio, *supra* note 30, at 416 (declaring that deregulation of the Savings and Loan industry in the United States was unsuccessful and led to crisis where "regulatory standards for sage and sound practices . . . were virtually nonexistent").
- <sup>90</sup> See Wu, *supra* note 63, at 160 (concluding that "the overall effect of the accord will be positive for the stability and efficiency of the international banking industry").
- <sup>91</sup> See Gard, *supra* note 2, at 194-95 (asserting that while Basel may work well for a stable banking system, the reliance on internal risk assessments will "increase risks, losses, and panic" in a banking crisis).
- <sup>92</sup> Basel II, *supra* note 9, at 52.
- <sup>93</sup> *Id.* Basel II does not require the internal ratings based approach, it is simply an option banks may use. *Id.* If they instead prefer to use the formulaic approach offered by Basel I, Basel II also contains a similar framework; see *id.* at 19-51 (detailing the categorical analysis of risk assessment carried over from Basel I).
- <sup>94</sup> See Harald Benink & George Kaufman, *Turmoil Reveals the Inadequacy of Basel II*, FIN. TIMES, Feb. 28, 2008, at 9 ("Bank capital-asset ratios are near historically low levels, typically at about 7 percent of total assets (on a non risk-weighted basis).").
- <sup>95</sup> See Wu, *supra* note 63, at 159 (identifying concerns related to lower capital retention rates which Chinese banks have with the internal risk assessment approach of Basel II).
- <sup>96</sup> See *id.* (describing the potential dangers in the eight percent requirement); see generally Chen, *supra* note 5 (analyzing the problem of non-performing loans in China and the measures which China has implemented in an attempt to shore up the banking sector, including the removal of non-performing loans from the market because they stripped the economic efficiencies from the market, and placed the banking sector in danger as it opens to the world).
- <sup>97</sup> See, e.g., Gard, *supra* note 2, at 193 (describing the problem of liquidity in assets as crisis looms, and the problem of allowing banks internal risk assessments, which will invariably be tied to the market liquidity of assets, as crises force drastic changes in asset liquidity); see also Basel II, *supra* note 9, at 52 (regulating international banking entities by allowing internal risk assessments to control the regulations of large, multi-national banks in determining capital reserve requirements, but retaining a more defined, simpler risk assessment based on categorizing a bank's assets); discussion, *infra* Section II.A.2 (explaining the new, flexible capitalization requirements present in the Basel II system).
- <sup>98</sup> See Benink, *supra* note 94 (identifying defaults of U.S. subprime mortgage products as a factor weakening the global banking market).
- <sup>99</sup> *Id.* (asserting that in dealing with U.S. subprime mortgages, "the internal risk models of many banks performed poorly and greatly under-estimated risk exposure, forcing banks to reassess and re-price credit risk.").
- <sup>100</sup> Compare *id.* (discussing the effect the subprime mortgage fiasco has on the global banking sector), with Finn, *supra* note 63, at 289 (indicating that the Chinese banks have "problems with bad loans, a lack of transparency, and significant corruption").
- <sup>101</sup> See, e.g., Wu, *supra* note 63, at 159 (asserting that adoption of Basel II may be difficult in Asia because of "the prohibitively high costs of making substantial upgrades to their banking structures").
- <sup>102</sup> Chen, *supra* note 5, at 242 (portraying the essential role banks played in China to allocate community capital, which the government used as part of its budget).
- <sup>103</sup> *Id.* at 244 (describing the pre-reform Chinese banking system as "a tool to support economic growth and an instrument to facilitate other reforms").
- <sup>104</sup> See BASEL CORE PRINCIPLES, *supra* note 77, at 4 (declaring that clear responsibilities of supervisory agencies are a "precondition for effective banking supervision").
- <sup>105</sup> See Halverson, *supra* note 5, at 327 (stating that China will open its financial sector to foreign investment); Finn, *supra* note 63, at 281-82 (describing the increasing U.S. investment in Chinese banks as taking advantage of Chinese accession to the WTO).
- <sup>106</sup> See Basel II, *supra* note 9, at 52 (turning over significant decision-making authority on risk classification to banks' internal procedures, changing the defined, transparent categorical approach required under Basel I).
- <sup>107</sup> See *id.* (allowing banks to calculate the risks associated with their assets instead of ensuring strong external control on the risk calculations).
- <sup>108</sup> See Finn, *supra* note 63, at 290 (asserting that Chinese banks lack sufficient transparency, possess inadequate risk assessments and other records, and suffer from widespread corruption).
- <sup>109</sup> See, e.g., Citigroup, Citigroup Global Locations, China, People's Republic of, <http://www.citigroup.com/citigroup/global/chn.htm> (last visited Apr. 9, 2008) (describing Citigroup's entrance into the Chinese market, particularly that Citigroup has "acquired a stake in Shanghai Pudong Development Bank ("SPDB"), and together with SPDB launched a dual currency credit card, the first of its kind in China"); Wachovia, Global Office Contacts – Asia, Australia and New Zealand, [http://www.wachovia.com/corp\\_inst/page/0,,14\\_982\\_4696\\_2769\\_2772,00.html](http://www.wachovia.com/corp_inst/page/0,,14_982_4696_2769_2772,00.html) (last visited, Mar. 27, 2009) (stating that Wachovia has branch offices in Shanghai and Hong Kong, and representative offices in Guangzhou and Beijing).
- <sup>110</sup> See, e.g., Basel II, *supra* note 8, at 2-3 (describing the internal ratings-based approach under the assumption that banks have internal ratings). Contra Finn, *supra* note 63, at 290 (citation omitted) ("In one often-repeated story, a former U.S. Treasury department official visiting a \$35 billion Chinese financial institution was shocked to find that there were no financial records at all.").
- <sup>111</sup> See, e.g., Wu, *supra* note 63, at 158-59 (noting that some Chinese banks believe a capital requirement of nine or ten percent might be more appropriate for China considering the more volatile banking sector there).
- <sup>112</sup> See *id.* (considering a higher capitalization requirement for Chinese banks).
- <sup>113</sup> Compare Wu, *supra* note 63, at 158-9 (stating that Chinese banks would probably prefer a nine to ten percent capital reserve requirement), with Tarbert, *supra* note 18, 789-93 (describing the internal ratings based approach to capital adequacy and concluding that Basel II will allow sophisticated banks to use a model based on internal risk assessments).

- <sup>114</sup> See Tarbert, *supra* note 18, at 189-93 (enumerating the advantages of an internal risk assessment to large, multi-national banks); see also Benink, *supra* note 94 (noting that actual capitalization by banks is likely to decline with the implementation of the Basel II framework due to the temptation to underestimate credit risk).
- <sup>115</sup> See Gard, *supra* note 2, at 176 (describing the impetus for Basel as a response to cross-jurisdictional banking issues and to “coordinate and establish regulatory conditions among banks to prevent” an international banking crisis due to differing regulations across borders).
- <sup>116</sup> Cf. Raj Bhalal, *Equilibrium Theory, the FICAS Model, and International Banking Law*, 38 HARV. INT’L L.J. 1, 11-12 (1997) (describing banks as necessarily global actors, only hampered by geopolitical boundaries so far as they effect the ability to conduct transactions and investments in global banking).
- <sup>117</sup> See *id.* (emphasizing that banks as market actors see little need for geopolitical boundaries); Finn, *supra* note 63 at 296-98 (describing the significant investment U.S. banks have begun to make into the Chinese marketplace).
- <sup>118</sup> See BASEL II, *supra* note 9 (relying on internal assessments, creating an opaque regulatory framework).
- <sup>119</sup> See Andrew Hurst, *Europe Governments Won’t Allow Banks to Fail*, INT’L HERALD TRIBUNE, Feb. 20, 2008, at 14 (chronicling the significant steps individual governments have taken in the wake of the current credit concerns to shore up confidence in the banking structure because of “the growing importance of financial services in a post-industrial economy and fear that a bank failure at the height of a global credit crisis could set off a cataclysmic chain reaction”).
- <sup>120</sup> See Benink, *supra* note 94, at 9 (asserting that the models which Basel II relies on have ineffectively estimated risk exposure in the past).
- <sup>121</sup> *Id.* (recommending that the Basel Committee conduct further evaluation, in the light of weaknesses the mortgage crises has exposed in Basel II).
- <sup>122</sup> See Barr, *supra* note 74, at 17 (“The Basel Committee is perhaps the most important example of a transgovernmental regulatory network that exercises vast powers, seemingly without any form of democratic accountability.”).
- <sup>123</sup> *Id.* (asserting that the Basel Committee has begun, in the development of regulation, to act in a more responsible manner, demonstrating “the possibility for enhanced accountability and legitimacy in international regulation” by opening its processes to proposed rulemaking to improve transparency).
- <sup>124</sup> See discussion, *supra* Section II.B.2 (describing the current Basel banking regulations). Compare Basel I, *supra* note 45 (outlining a transparent risk assessment basis for discounting capitalization), with BASEL II, *supra* note 9 (allowing banks to use internal ratings which may better mirror actual risk exposure).
- <sup>125</sup> Compare Comizio, *supra* note 30, at 415 (stating that deposits in the United States are “underwritten at the expense of U.S. tax dollars”), and FDIC Mission, *supra* note 66 (outlining the deposit insurance scheme in the United States), with Finn, *supra* note 63, at 289 (stating that Chinese banks do not have deposit insurance, but must obtain central government permission to liquidate in the case of bankruptcy).
- <sup>126</sup> *Contra* BASEL II, *supra* note 9, at 1 (discounting their own responsibility by only “encouraging [supervisory authorities] to consider adopting this revised Framework at such time as they believe is consistent with their broader supervisory priorities”).
- <sup>127</sup> Compare discussion, *supra* Section III.A (arguing that Basel II is binding customary international law), with Gard, *supra* note 2, at 162 (asserting that even though central bankers, instead of governments, promulgate or approve the Basel Committee’s decisions, Basel II is a global regulatory scheme).
- <sup>128</sup> Cf. General Assembly Powers, *supra* note 69.
- <sup>129</sup> Cf. U.N. Charter art. 11, para. 1 (granting the General Assembly the authority to “consider the general principles of co-operation in the maintenance of international peace and security, including the principles governing disarmament and the regulation of armaments . . .”).
- <sup>130</sup> See BASEL II, *supra* note 9, at 1 (“encouraging [supervisory authorities] to consider adopting this revised Framework at such time as they believe is consistent with their broader supervisory priorities”).
- <sup>131</sup> See, e.g., *id.* (asserting only that “[t]he committee expects its members to move forward” and adopt the Framework). The Basel membership is only the G-10 nations (Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States). *Id.*, see also About Basel, *supra* note 36.
- <sup>132</sup> *Contra* BASEL II, *supra* note 8, at 1 (asserting that each national regulatory authority should consider implementing the Framework).
- <sup>133</sup> Cf. BASEL II, *supra* note 9, at 52 (setting out the flexibility of internal ratings assessments to determine risk). The current framework emphasizes the flexibility of having risk determine capital adequacy. *Id.* In doing so, it fails to ensure strong regulation to ensure that banks are sufficiently capitalized. *Id.*
- <sup>134</sup> Cf. Wu, *supra* note 63, at 159 (noting the apprehension surrounding an eight percent requirement in China).
- <sup>135</sup> Compare BASEL I, *supra* note 45 (instituting a transparent formula for comparing investment risk with capitalization requirements), with BASEL II, *supra* note 8 at 52 (allowing banks to use internal risk approaches to determine capitalization requirements).
- <sup>136</sup> See, e.g., Tarbert, *supra* note 18, at 775 (noting that taxpayers pay for a bank bailout in the case of national deposit insurance); Conroy, *supra* note 20, at 2414 (describing the costs associated with the consumer protections deposit insurance provides).
- <sup>137</sup> See Gard, *supra* note 2, at 176 (construing that the purpose of the Basel Committee is to help fill gaps resulting from differing regulatory schemes operating in different nations, a phenomenon which previously led to economic disasters).
- <sup>138</sup> Cf. Finn, *supra* note 63, at 288-89 (discussing U.S. entrance into the Chinese market, where U.S. banks have to consider the lack of deposit insurance and Chinese banks effectively must receive permission (which has never been given) to go bankrupt). Consider the implications of a U.S. bank, with Chinese deposits, going bankrupt in the United States. Cf. *id.* (describing the transnational approach of S.E.C. disclosure regulation). Theoretically, the U.S. deposits would be insured by the FDIC, the bank could go bankrupt under U.S. law, and Chinese depositors’ only recourse would be a government bailout. Cf. *id.* (discussing an opposite problem of U.S. banks purchasing non-controlling stakes in Chinese banks who do not keep paperwork which a U.S. bank would be required to turn over to the S.E.C. on demand).
- <sup>139</sup> See generally Comizio, *supra* note 30 (enumerating some necessary safeguards which must be taken, such as adequate capitalization regulation, along with a deposit insurance regime in order to protect consumers and taxpayers from bank owners and managers who otherwise would invest in high-risk/high-reward investments).
- <sup>140</sup> See Finn, *supra* note 63, at 288-89 (enumerating U.S. banks’ investment in Chinese banks); Halverson, *supra* note 4, at 327 (describing China’s obligations under WTO accession); see generally Joseph J. Norton, *International Academy of Commercial and Consumer Law Changing Law for Changing Times, 13th Biennial Meeting: Banking Law Reform and Users-Consumers in Developing Economies: Creating an Accessible and Equitable Consumer Base from the “Excluded”*, 42 TEX. INT’L L. J. 789 (chronicling the banking reforms and system development in under and un-developed nations).
- <sup>141</sup> See generally Comizio, *supra* note 30 (espousing the benefits which deposit insurance brings to the U.S. banking system).
- <sup>142</sup> See Kathleen A. Scott, *Deposit Insurance Systems Around the World*, N.Y. L.J., Sep. 7, 2005 (describing the varying ways different nations have instituted deposit insurance regimes).
- <sup>143</sup> See Scott, *supra* note 142 (showing that different nations require different levels of insurance); discussion, *supra* Section III, deposit insurance, expressed in real terms (e.g. FDIC insurance up to \$100,000 in the United States), should be required worldwide and the amount of insurance should vary according to the financial circumstances of nations; cf. BASEL II, *supra* note 8, at 1 (declaring that supervisory authorities should consider their own circumstances in implementing capitalization requirements). However, this comment argues that capitalization requirements, expressed in percentages, should be implemented globally.
- <sup>144</sup> See, e.g., FDIC Mission, *supra* note 66 (insuring U.S. deposits to 100,000 U.S. dollars); CDIC Overview, *supra* note 27 (insuring Canadian deposits to 100,000 Canadian dollars); U.K. Deposit Insurance Overview, *supra* note 27 (insuring British deposits to 35,000 British pounds).
- <sup>145</sup> Compare CENTRAL INTELLIGENCE AGENCY, THE WORLD FACTBOOK: SWITZERLAND, <https://www.cia.gov/library/publications/the-world-factbook/print/sz.html> (declaring the per capita Gross Domestic Product (GDP) of Switzerland as 40,900 U.S. dollars), with CENTRAL INTELLIGENCE AGENCY, THE WORLD FACTBOOK: CHINA (2009), <https://www.cia.gov/library/publications/the-world-factbook/print/ch.html> (declaring the per capita GDP of China as 6,100 U.S. dollars).
- <sup>146</sup> See sources cited *supra* note 145 (demonstrating that differing levels of insurance are appropriate for different nation’s economic systems).