

International Bank Regulation in the Pre-Basel Era and the Theory of Club

Governance- Presentation

1. Introduction

Thank you very much for having me, my name is Joanna Wilson and I am a Lecturer in Commercial Law at the University of Sussex. This paper that I am presenting today is concerned with the extended history of the regulation of international banking and it challenges the common perception that regulation in this area only began in 1974 when the Basel Committee was formed and tasked with the promotion of stability in the global financial system through, among other things, the placing of micro-prudential controls on the activities of internationally active banks.

Whilst it is undoubtedly true that it is only in recent years that banks have been subject to formal control at a global level this does not mean that the regulation of international banking has not been characterised by some other form of governance throughout history.

Accordingly, the hypothesis here is that the regulation of international banking is not a recent occurrence and actually the international banking industry was subject to an alternative form of governance in the pre-Basel era. This hypothesis was reached through an analysis of the rationale that underpinned the formation of the Basel Committee itself in 1974 and the introduction of controls being placed on banks at an international level. The motivation behind this new form of governance was the rapid globalisation of financial services in the post-war era, as well as the collapse of the Bretton Woods system of fixed exchange rates and the failure of two international banks, all of which raised concerns over the ongoing stability

of the international financial system. So it was the systemic risks created by the globalisation of the banking industry and the resulting interconnected economic environment that prompted these concerns leading to the introduction of controls being placed on banks at an international level.

However, and what is most important here, is the fact that international banking is not a recent phenomenon and issues pertaining to the maintenance of stability in the global economy that result from the systemic implications of having an interconnected financial system have resonated throughout history.

While the work of the Basel Committee on Banking Supervision, which includes the ex-ante regulation of the international banks themselves, encapsulates the contemporary method of governing these issues, what this paper seeks to do, in light of the abovementioned fact that international banking is not a recent phenomenon, is analyse the historical method of governing them. In contrast with its modern counterpart, it is argued that the regulation of international banking throughout history was characterised, not by the placing of formal controls on the individual market participants, but by a form of self-regulation which hinged on the informal cooperation of the international bankers themselves. This, I argue, is similar in some respects to the club governance style of regulation which Michael Moran explains ruled the financial landscape of the City of London itself up until the late 1970's.

So essentially what this paper is doing here is applying a domestic theory on regulation in an international context in an attempt to explain the extended history of the regulation of international banking.

2. Origins of International Banking

So this paper is underpinned by the question of when international banking originated and how it developed over time. To give you a very quick overview:

International banking actually originated in the eighteenth century when merchants began to turn their attention away from commerce, focusing instead on the provision of credit to facilitate international trade. The eighteenth century had seen an explosion in international commerce and it was the merchants who exploited the new opportunities that this created by providing the means through which payments could be made. The method of payment used in an international context was the bill of exchange and these merchant banks would provide a guarantee for settlement of the bill upon its presentation to them. The role of these merchant bankers as international financiers, both in the field of accepting bills of exchange, and also in relation to the issuing of foreign loans, grew steadily throughout the nineteenth century when the likes of Barings established themselves as the leading investors in American trade, and Rothschild successfully spread their network of branches across Europe.

The 1870s marked the beginning of a 50 year period of rapid globalisation, sparking unprecedented growth in capital flows and trade which, combined with the expansion of transportation and the enhancement of communication, facilitated the development of international banking further. Accordingly, it was during this era that the global economy became truly interconnected; the links between financial centres became stronger and the

gold standard was globalised, bringing stability to international monetary transactions. The onset of war in 1914, which was followed by the Wall Street Crash in 1929, an ongoing state of depression in the 1930s and further conflict in the early 1940s, put a halt to this period of globalisation and led to the implosion of international financial activity across the globe.

However, the post-war era saw the revival of the global economy and the evolution of international banking through the introduction of capital markets such as the international inter-bank market and the Eurodollar market which were fundamentally separate from the earlier trade related economies on which international finance had been based. Stability was restored as a result of the Bretton Woods agreement in 1944 and this facilitated the rapid expansion of trade and international finance. However, when the Bretton Woods system of monetary management came to an end in the 1970s, concerns were raised regarding the stability of this newly energised international financial system and it was at this time that the Basel Committee was formed, and international banks became subject to control.

So although the international banking system that characterises the modern world is quite unrecognisable when compared to the global nature of the industry from an historical perspective, this does not mean that systemic issues were not raised under the previous trade related international banking system.

3. Regulation

In terms of regulation then, the international nature of banking and the interconnectedness of financial centres raise a series of implications and complications in terms of regulation and the maintenance of international financial stability. For example, there is the concern that because of the connection between financial markets, economic disturbances in one

jurisdiction can lead to instability in another, and there is the ‘too big to fail’ argument which centres around the premise that some banks have such systemic importance in terms of the stability of international financial markets that they must be rescued in the event that they face difficulty.

These issues are not peculiar to the modern world. These issues did not occur only in the post-war era. For example, in 1890 Barings Bank- which was probably the biggest bank in the world at the time- faced bankruptcy, and if it had been allowed to fail, not only would London’s status as the leading financial centre of the world been jeopardised, but also, because of the extent to which Barings engaged in international transactions, it would have undoubtedly caused wider financial disturbances across the globe.

Now the cumulative effect of these types of issues in a modern context was that there was increasing pressure to adopt a formal international regulatory response in order to maintain stability. Whilst much has been documented about this response in terms of the work of the Basel Committee over the past 40 years, what this paper is concerned with is the way international banking was regulated in the pre-Basel era. This is where the theory of club governance comes into play.

4. The theory of club governance

Moran’s theory of club governance is analysed in his book *The British Regulatory State: High Modernism and Hyper Innovation* and it essentially provides that in an historical sense, the City of London is special in terms of its economy because of the self-regulatory style of governance that the financial services industry adopted. Accordingly, Moran argues that in the pre 1970s era the banking sector was characterised by uncodified, unorganised and

unjuridified systems and in contrast, the period from the 1970s onwards, which represents the modern age of regulation, saw the replacement of these informal systems with more formally organised more elaborately codified and more legally bound state control systems.

Moran argues that in this historical period, regulation was underpinned by the close personal relationships of the bankers themselves and it existed only in the form of cultural restraints and the subtle exercise of social controls conducted via the creation of club-like bodies such as the Stock Exchange and the Accepting Houses Committee. He argues that the Bank of England was the linchpin of this informal cooperative system, assuming the position of central bank and prudential regulator. He summarises the regulatory environment by stating that “By the beginning of the twentieth century, the culture of the City elites...fostered a style of regulation that emphasized informality, collegiality, and cooperation.”

Essentially then, Moran’s theory on the regulation of the financial services industry throughout history, was that it revolved around the close, personal relationships of the bankers themselves and the informal cooperative practices that they adopted in order to maintain an efficient system and this behaviour was institutionalised through clubs and organisations such as the Stock Exchange.

5. Applying the Theory in an International Context: Its Limits and Utility

There is no doubt that Moran’s account of the regulatory history of financial services provides a valuable insight into the way the banking industry was governed in the UK in the pre 1970s era. However, the limitation of his theory is that it focuses only on the domestic dimension of the industry, emphasising the social and economic connection between the

bankers of London itself through club-like bodies and the informal pressure exerted by the Bank of England as manager of the system. Accordingly, what Moran fails to take into consideration is the international nature of the banking industry, the implications that this raises in terms of governance, and whether any form of regulation took place in order to maintain the global economy across national boundaries.

Having said that, Moran's explanation, even though only in a domestic context, is useful in terms of aiding our understanding of what might have been happening at an international level. Thus, the value of Moran's theory is that it portrays 'regulation' as a much more fluid concept than the more rigid, rules based modern perception of the term. He provides a theory of regulation that rests, not on the law or on a formal adoption of principles, but on the relationships between market participants, the informal cooperation that existed between them and the subtle exercise of control they exerted upon one another. In particular, Moran provides a useful comparison of the characteristics of the pre and post 1970s regulatory environment and if we apply these characteristics in an international context it will be seen that the work of the Basel Committee on Banking Supervision, as the body concerned with the regulation of the international banking industry in a modern context, clearly represents this more formally organised, more elaborately codified and more legally bound system of regulation. The question that this raises then is whether, in similar vein to Moran's domestic theory of regulation in the pre 1970s era, the international banking industry was ever subject to a more informal approach to regulation.

So did a form of 'international club governance' ever exist in the pre-Basel era?

6. International club governance

In analysing whether similar characteristics could be said to have featured in the governance of the global economy, this paper argues that although not identical, the regulation of the international banking industry throughout history did strike some similarities to Moran's domestic theory.

In the pre-war era, this cooperative style of informal regulation focused on ex-post crisis management where banks would come to the rescue of their counterparts across national boundaries in times of financial distress. The paper gives several examples of this taking place from the eighteenth century up until 1914. Using the Barings crisis of 1890 as an example, the Bank of England, with reserves equally only half of Barings liabilities, was unable to act as the sole lender of last resort and so, in order to strengthen their dubious position, they were able to beg a loan of £3 million from the Bank of France. This was orchestrated using the connection between Rothschild in London and his cousins in Paris who in turn communicated with the Bank of France and was able to secure the loan. Now the Bank of France were amenable because of their acute awareness of the connection between financial markets and the fact that had Barings Bank gone down, a dangerous monetary crisis would have ensued in London, and this would no doubt have spilled onto the French market. So what this transaction meant was that the central bank in London received a much needed injection of liquidity and an international financial crisis was averted.

There are many other instances similar to this that occurred throughout history and what this paper argues is that this was the starting point in the governance of international banking- this was the way in which the global financial system was managed- not through the placing of controls on the banks themselves in order to bolster stability- but through informal ad hoc

crisis management which often rested on the international business or familial connections that existed between bankers across national boundaries and their desire to protect their domestic financial system from the risk of contagion that arose because of the interconnection between national economies.

The paper argues that this behaviour developed along closer lines to Moran's theory in the inter-war period, particularly in the context of the institutionalisation of cooperation through a club-like body that was analogous to an organisation such as the Stock Exchange in London. One of the central characteristics of Moran's notion of club governance was the role of club-like bodies in forging the close personal relationships between bankers and facilitating the collaborative practices that they engaged in. As Moran explains, it was through clubs and institutions such as the Stock Exchange and the Accepting Houses Committee that this informal system of management based on cooperation and collegiality became institutionalised; it was these associations that provided the forum for bankers to meet on an unofficial basis and govern the financial services industry through informal collaboration.

It is argued that it was that during the inter-war period that the first steps were taken towards the transformation of this international form of governance from a system based on informal cooperative practices, to a more entrenched form of management; Firstly, bankers were brought together at the inter-war conferences to discuss the future of central bank cooperation directly. Secondly, central bankers began to develop personal relationships with one another, the relationship between Montagu Norman of the Bank of England and Benjamin Strong of the Federal Reserve Bank of New York being the most celebrated example of this, and this

suggests that the personal relationships that existed among the club like organisations of the City of London itself were beginning to be emulated at an international level. Finally and most importantly, the Bank for International Settlements was born which provided the 'club' through which the most powerful bankers in the world would meet and coordinate their policies in order to maintain stability in the global economy. The informal monthly meetings of the central bankers that took place there were the hallmark of this international system of governance and the lender of last resort functions performed by the Bank, either on its own account, or in providing the forum through which to arrange international consortiums, shows how important the cooperative practices were at the institution in multilaterally stemming international financial crises. So as well as providing the opportunity for central bankers to meet, forge friendships and exchange information, all of which provided the foundation for this club governance style of regulation, the BIS also enabled these bankers to pool their resources and coordinate their actions when it came to the maintenance of stability on the global economy through the rescue of other central banks. An example of this coordinated action was the assistance offered by the Bank for International Settlements and its members to the Austrian National Bank in the early 1930's following the collapse of the monumental Credit-Anstalt Bank. When this news was made public, the Austrian banks began to suffer heavy withdrawals and so the Austrian National Bank sought international cooperation in raising a standby credit in order to cover their own losses. Whereas ordinarily, the Austrian National Bank would have relied on the cooperation of another central bank or group of private banks in raising the necessary liquidity, Norman, Governor of the Bank of England instead referred the Austrian authorities to the Bank for International Settlements, highlighting that this international institution was now the appropriate forum to coordinate such global action. As a result of this a loan of 100 million shillings was made available to

the National Bank, 40 million of this being made available by the BIS itself and the remaining 60 million being raised by eleven central banks through the agency of the BIS.

This type of cooperative behaviour continued in the post-war era but by the early-mid 1970s, international financial markets had been subject to a complex makeover, meaning that the industry was exposed to new levels and types of risk and it was in this climate that the call for an appropriate regulatory response became more acute. From this pressure, the Basel Committee on Banking Supervision was born, an international organisation formed by the G10 regulators and central bank governors based at the BIS, which was designed to coordinate financial affairs on a more systematic basis and harmonise regulatory standards across the globe.

Accordingly, the closing argument here is that the year of 1974 did not mark the beginning of the regulation of international banking but rather, it represented a shift away from a system of governance that rested on the relationships between commercial and central bankers where crisis management was dealt with on an informal ex-post basis, towards a system of governance, still based at the 'Basel Club', but one that was more formal and systematic and involved the ex-ante regulation of the banks themselves.