Supervisors against regulation?
The Basel Committee and country risk before the International Debt Crisis (1976-1982)

While the International Debt Crisis of the early 1980s was the most severe financial crisis since the Second World War and while national and international banking supervision was developing at that time, little is known about the response of supervisors to the deteriorating financial environment in the preceding years to the crisis. Complementing the political and business history of the international debt situation, this article aims to unravel the international banking supervision side of the question. Based on archival material from the Bank for International Settlements and various central banks, the article examines how the Basel Committee on Banking Supervision, then emerging as the leading forum on international banking supervision, anticipated the International Debt Crisis through the prism of 'country risk'. The article shows that the Committee refused to recommend strict regulations in this area. It argues that they adopted this position because of the lack of good information and of the difficult position of banking supervision between macroeconomic issues and individual banks' own responsibilities, but also because of somewhat excessive faith in market mechanisms. Their discussions on country risk shed light on critical challenges of banking supervision and, thereby, on the history of banking regulation and prudential thinking.

Keywords: Basel Committee on Banking Supervision, country risk, International Debt Crisis, financial regulation.

JEL codes: N20, N40, N8, E50, F34

‘There have been other examples of risks which supervisory authorities only recognized at a late stage, such as country risks. I know of no supervisory authority that issued a real warning signal to the banking system in time.’

Dr. A. Batenburg,
Former chairman of the Managing Board of the *Algemene Bank Nederland N.V.*,
4th International Conference of Banking Supervisors,
Amsterdam, 22nd-23rd October 1986

The Eurozone crisis has put to the fore the importance of country risk for banks and supervisors and the potentially dramatic economic, social and political consequences of a default by a major borrower. A crucial move in banking supervision occurred in the wake of the crisis, with the establishment of the Banking Union from 2012 on (for an overview of the progressive establishment of Banking Union, see Véron 2015). However, this was not the first time supervisors and banks dealt with country risk in international banking: although certainly not the oldest example of country risk for banks, the 1970s boom of international lending, leading to the International Debt Crisis of the early 1980s, provides a case in point because supervisors had for the first time a forum to discuss their issues on a global basis: the Basel Committee on Banking Supervision.[1]

While the early 1980s International Debt Crisis was probably the most severe financial crisis since the Second World War and while the Basel Committee on Banking Supervision (BCBS) was then emerging as a leading body in international banking supervision, surprisingly little is known about the Basel Committee response to the deteriorating financial environment in the preceding years to the crisis. This is all the more surprising since the Basel Committee spent a considerable amount of time to discuss the increasing risks for banks of many developing countries’ rising external indebtedness. This small notoriety is arguably due to the fact that archival material on that period only recently became available, and that the Basel Committee’s discussions on the international debt situation did not lead to a major decision, contrary to well-known achievements such as the agreement of 1988 on an international standard for banks' capital adequacy, known as Basel 1. However, the discussions on the issues of international lending and risk, which took place under the label of country risk, revealed essential challenges of international banking supervision at the time, challenges which are still widely debated today, such as the problematic combination of micro and macroprudential considerations, the issue of moral hazard, or the need for good information (Aikman et al. 2013).

Since the Basel Committee was the first forum discussing international supervisory and regulatory issues on a large international scale, the way it anticipated and handled the situation leading to the debt crisis provides an early example of global reflection on how to preserve financial stability from a banking supervision perspective. The IMF has logically received more attention than the Basel Committee, and even than the Bank for International Settlements which hosted the Basel Committee: this is to some extent normal, given the important role the IMF had in the handling of the crisis and the fact that the Basel Committee was just an expert committee. However, as a central institution for banking supervision, the Basel Committee provides a very useful case to better understand the history of international banking supervision and prudential thinking. This is of particular importance because banking supervision was then a growing activity which would eventually become a central element in the political economy of global finance (Singleton 2011, pp. 227-236, Davies 2015, p. 71, see also Deeg and O'Sullivan 2009, Busch 2010). This article is therefore not primarily about the International Debt Crisis or the notion of country risk, but about how international banking supervision dealt with the deteriorating international financial situation eventually leading to the debt crisis. Examining the discussions of the Basel Committee on country risk sheds light on the process of regulation, and not only on its success results and failures.

The literature on the history of banking supervision and regulation and on the Basel Committee too often stays at the level of state bargaining and major regulations, such as the successive Basel agreements on capital adequacy (Kapstein 1994, Wood 2005, Tarullo 2008, Singer 2010). When it delves more into the history of banking supervision, it focuses at times on providing ‘lessons from the past’ (See for instance Eichengreen 2002, Gigliobianco and Toniolo 2009). Recently, several archival-based studies have been published on the beginnings of international banking supervision, but they deal with individual failures or European integration and not with financial crises (Schenk 2014, Mourlon-Druol 2015, Mourlon-Druol 2016). The extensive study of the Basel Committee by Goodhart, while providing a detailed narrative of the Committee’s history, significantly minimises the work done in the area of country risk, and does not relate it to the national and international contexts of the time nor to the evolution of banking supervision and regulation over time. (Goodhart 2011, pp. 132-141).[2] Another drawback of the literature on the history of financial regulation is the tendency to consider financial stability as a static concept, even when it is recognised that financial stability has not always figured prominently in regulatory agenda compared to monetary concerns (Toniolo and White 2015). This article goes further and shows that the 1970s upheavals in international banking were a turning point for banking supervision, as supervisors formulated the articulation of micro and macroeconomic issues in the financial sector in a perspective that would be long-lasting.

On the other hand, the vast literature dealing with the International Debt Crisis has mostly focused on the role of the IMF and governments (James 1996, Bartel 2017), or commercial banks (Devlin 1989, Alvarez 2015, Bartel 2017, Altamura 2017), and the role of international banking supervision is still poorly understood. This is all the more problematic since several studies have already stressed the role of the Bank for International Settlements, which hosted the Basel Committee, in its efforts to prevent from an excessive indebtedness of

Latin American countries, but also in the early discussions of 'macroprudential' issues, that is the prevention of systemic financial crises (Clement 2010, Maes 2011, Altamura 2017. For a general history of the Bank for International Settlements, see Toniolo 2005). Complementing the political and business history of the international debt situation, this article aims to unravel the international banking supervision side of the question.

The preceding years to the international debt crisis were the occasion of much supervisory debate on country risk and on the possible actions to take to prevent a large-scale crisis. The crisis itself is often considered to have started with the August 1982 Mexican default on its external debt, but recent research has shown that the 1981 Polish debt rescheduling was what triggered a panic about sovereign lending among banks and regulators around the world (Bartel 2017). While there are many ways to define 'country risk,' the article will look at how Basel Committee members and regulators of the time approached it. Between 1976 and 1982, the BCBS usually defined country risk as the risk 'that foreign borrowers whose liquidity or solvency is not in question may, because of balance-of-payments or political developments in their home countries, be unable to service and repay their debts.'[3] Country risk thus had an economic and a political dimension, and was therefore close to political risk. However, in the second half of the 1970s, the notion of country risk superseded the narrower notion of political risk in order to include other risks implied when banking across borders, most notably balance-of-payments issues (Toksöz 2014, p. 10). Supervisors were not only concerned with sovereign lending, but also with lending to foreign private borrowers who could be prevented from repaying their debt because of measures taken in a country to preserve the balance of payments.

In this article, I examine the BCBS' discussion of country risk supervision and argue that it refused to advocate strict bank regulation of international lending, even if it knew well in advance the potential risks implied by the rising exposure to indebted countries. This position can be ascribed to three principal obstacles to the evaluation of country risk by supervisors: their microprudential focus and reluctance to take the responsibility for banks' risk management; their failure to secure an agreement between themselves and with other more macro-oriented regulators; and the lack of information. Their attitude also indicated a somewhat excessive reliance on market mechanisms. The article further shows that the United States were more active in the BCBS' work on country risk supervision. The article first briefly summarises the context, the role of banking supervision and of the BCBS in the international regulatory arena, then analyses the three obstacles in sections two, three and four. Section five considers the steps eventually taken by the BCBS to prevent from excessive country risk in the early 1980s. Section six offers a conclusion. The article draws on material from the BIS, the Bank of France, the Bank of England, and the Federal Reserve Bank of New York.

I

The 1970s saw a rapid expansion of international bank lending to developing countries, particularly after the first oil shock had led to the 'petrodollars' recycling phenomenon (Altamura 2017). In parallel to the on-going growth of international and multinational banking since the 1960s, large international banks massively invested in the developing world, because it was considered more profitable than domestic banking and as carrying little risk (James 1996, Cassis 2011). Private lending overtook public lending to developing countries in the early 1970s.[4] After the first oil shock, the Federal Reserve, together with international organisations such as the IMF, the OECD and the BIS, considered international lending as an essential element of the recycling mechanism and therefore encouraged it (James 1996). International lending enjoyed a good reputation, famously illustrated by the chairman of Citicorp Walter Wriston's comment that 'countries don't go bankrupt' (James 1996, p. 352). By 1979, aggregate international assets of U.S. banks were five times more important than in 1971, and for some major banks they represented more than half of total assets.[5] According to the BIS data, gross borrowings of 'non-OPEC LDCs' (Less Developed Countries) had grown by $14.3 billions on average every year between 1974 and 1977. They grew more sharply at the end of the decade to reach an increase of $39.9 billions in 1981 and a total of $246.9 billions at end 1982. For Eastern European countries annual increases had been of $5.1 billions every year between 1974 and 1977 and reached a total of $53.3 billions at end 1982 (see table 1).[6]

{please place Table 1 near here}

Developing countries' banking sectors, particularly in the Mexican case, became more vulnerable as domestic banks heavily relied on the international interbank market to finance their activities (Alvarez 2015). By the end of the 1970s, these countries were severely affected by the second oil shock, high world interest rates and the world economic recession (Devlin 1989). Turkey, Zaire and Peru were already rescheduling their debts in the second half of the 1970s.[7] Even Mexico had already been through a debt crisis in 1976 which had led to the intervention of the US administration and the IMF (Kershaw 2018). The situation dramatically worsened with the Polish debt rescheduling in 1981, and the Mexican default in August 1982 triggered a panic among large international banks. In the 1980s, over fifty countries would start a rescheduling procedure (Altamura 2017, p. 196).

International lending had unusual characteristics in the 1970s. The loans to sovereigns increasingly took the form of syndicated loans, where US American banks had been particularly instrumental in inviting other banks. For newcomers, in particular Japanese banks, this represented a facilitated entry to a new market such as Latin America, and for American banks, this was a way to diversify risks (Katada 2008). Syndicated loans existed for a long time, but before the Second World War they mostly existed at the domestic level, whereas in the 1970s they had gone global (Altunbaş et al. 2006). The market for international syndicated loans first developed in the 1960s with the Eurodollar market, and evolved in the 1970s to focus more on sovereign lending in emerging economies (Altunbaş et al. 2006, Battilossi 2010). Syndication also participated to lower banks' perception of risk, as they thought they had diversified them properly. This was particularly the case for smaller and less informed banks participating in syndicates, an issue frequently mentioned by Basel Committee members.[8]

However, country risk exposure was not just an American history. By the early 1980s, European and Japanese banks had grown to such an extent that they figured among the biggest banks of the world. According to *The Banker* 1980 ranking of the ten biggest banks, seven were European, two of were from the United States, one from Japan, and the Japanese share was rising fast.[9] According to a study of the Bank of France, by 1983 the exposure of Western and Japanese banks' to indebted countries was distributed as follows: banks from the United States represented 40 per cent of total lending, Japanese banks 25 per cent, United Kingdom banks 15 per cent, French banks 8 per cent, German banks 7 per cent.[10] Even though these numbers are to be considered with care as the lack of accurate data was precisely a key issue of the period, they show that Japanese and European were very important actors of international lending. Exposure varied significantly from one bank to another: in France, the Crédit Commercial de France was particularly fragile because its exposure was poorly covered by provisions.[11] In the United Kingdom, Midland and Lloyds were particularly exposed to Latin America, with respectively 205 and 165 per cent of their capital exposed at end 1984 (Altamura 2017, p. 234).

Regulators had trouble defining country risk precisely, and even more to measure it. The concept of country risk can be set within the context of a broader history of probability and the various ways that have been devised to measure and predict risk by mathematicians, economists and practitioners, but it is also closely intertwined with political power, colonial, post-colonial and Cold War contexts (Toksöz 2014, See also Krayenbuehl 1985). If the term country risk was widely discussed in the 1970s, this was not a new phenomenon. Major payment crises had existed for a long time, from the nineteenth century Latin American debt crises to the Bolshevik debt repudiation in 1918 and various expropriation acts following the Second World War (Marichal 1989, Dawson 1990, Malik 2018). In the 1970s, authorities from the Group of Ten countries (G10) started to worry about the risk of possible default or balance-of-payment issues for individual banks but also, more generally, about the risks of increasing international lending for the financial system as a whole.[12] Foreign lending was increasingly considered by authorities as less safe than domestic lending for various reasons, including the absence of any clearly defined lender-of-last-resort responsibilities, but also because of all kinds of possible events that were possible when banking across borders, such as socio-political changes or measures taken in the borrowers' country (expropriation, exchange controls), natural disasters, world depression or oil price rise. Country risk was primarily a microprudential concern, that is a concern for the individual bank. However, in the context of the 1970s rise in international banking and general indebtedness of developing countries, supervisors could not ignore the risks run by the financial system as whole, and therefore the macroprudential dimension of the problem.

At the same time, the BCBS was emerging as the most important international body specialised in banking supervision. Established in late 1974 by central bank governors from the Group of Ten countries after a series of banking failures in the United Kingdom, the United States and Germany, it met at the Bank for International Settlements in Basel, Switzerland. In its early years, the BCBS was meant to help the G10 central bank governors in their task of preserving the stability of individual banks and of the banking system as a whole. Initially, the Basel Committee was just an expert committee, although an important one, and would gain major regulatory power over time, as it became the global standard-setter for banks' capital adequacy (Boey 2014). The Committee was composed of high-ranking banking supervisors and foreign exchange specialists from the twelve member countries (the Group of Ten plus Luxembourg and Switzerland), all coming from central banks and supervisory institutions. It thus represented the creditor countries, not the borrowing countries. Its initial remit was balanced between bank supervision and foreign exchange governance.

Banking supervision was an activity with marked national characteristics and different levels of development. In some countries like the United States, banking supervision existed since the early nineteenth century, while in some others like the United Kingdom, where informal supervision was still widely used, it had just been established in 1974 (Mitchener and Jaremski 2015, Capie 2010, p. 654). Many countries (Belgium, Switzerland, Germany, the United States) had established or extended a formal system of banking supervision in the 1930s in the wake of the financial and economic crisis (Giddey 2012, Feiertag and Drach 2018). By the early 1970s, banking supervision still often had limited staff and resources, but was the only profession really focused on the prudential dimension of regulation, that is on protecting depositors and ensuring that individual banks were not taking excessive risks, as opposed to the monetary dimension of regulation, which then formed the primary motive of banking regulation (for the case of France, see Monnet 2018). In all cases, banking supervision focused on the scale of the individual bank, as opposed to the system as a whole, and used tools such audit and accounting data, or direct discussion with banks' management, more than macroeconomic statistics, to perform its tasks. This microeconomic focus would have decisive consequences in banking supervisors' assessment of the international debt situation in the late 1970s.

II

By the mid-1970, supervisory thinking about country risk at national level was still very preliminary, except in the United States. When the Basel Committee first addressed the topic in March 1976, the chairman (Blunden, Bank of England) stated that he believed that 'among the members of the Committee the United States had probably done most work in the field of country risks.'[13] The United States were more concerned about country risk because their banks were particularly and increasingly exposed to it. By 1981, US banks' exposure to the Latin American debt reached 97.3 per cent of their capital and was well above 100 per cent in several individual cases (James 1996, p. 352). American regulators, however, also disagreed among themselves. For example, in March 1976, the Comptroller of the Currency, James Smith, testified before the US Senate Banking Committee that his institution had 'undertaken in the examination of international banking activities to classify and comment on international lending activity on the basis of sovereign or country risk' and that it was 'the only examining agency that so comments on international lending.'[14] A month earlier, in February 1976, the Federal Reserve governor Holland had claimed before the same committee that: 'country risk exposure is too sweeping a label for a useful analysis of risk in international operations […]. The idea of a country risk concept, I believe frankly, is obsolescent if not obsolete.'[15] This hesitant state of mind changed throughout the decade, however, and the United States became much more active in the area of country risk by the end of the decade. In 1979, they set up an Interagency Country Exposure Committee gathering people coming from the three Federal regulation agencies (the Federal Reserve, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency).[16] They were also instrumental in training and providing bank examiners to the IMF who send them to regulatory agencies in other countries.[17]

The political economy of international finance in the second half of the 1970s revolved around the recycling issue. To some extent, the first oil shock had been considered as successfully absorbed by Western and Japanese banks. The financial system had handled the flows properly, which had itself reduced the perceived need for surveillance (James 1996, p. 349). Several commentators spoke of a miracle (Altamura 2017). The IMF, the BIS, and the Working Party 3 of the OECD which was focusing on international monetary and financial issues all put to the fore the efficiency of the private sector in the recycling mechanism. When the second oil shock arrived, the same approach was hoped to work: 'The IMF, the BIS and WP3 of the OECD never questioned in a credible way the approach adopted to deal with the first oil crisis, and commercial banks in the West continued to expand their operations in the developing world.' (Altamura 2017, p. 196). Because it considered international banks were playing a key role in the recycling mechanism, the BIS was overall opposed to the regulation of international lending, as was the IMF, even though different opinions could coexist within these organisations.

The Group of Ten countries disagreed about what to do in international banking, and particularly concerning the Eurodollar market. In the early 1970s Germany had been a proponent of regulatory measures in this field, in the form of minimum reserve requirements on Eurodollars, because it feared the effects of the Eurodollar on interest rates, unemployment and inflation (Altamura 2017, p. 199). It submitted again proposals for coordinated regulation of the Euromarket in the late 1970s, slightly before the second oil crisis. On the contrary, the United Kingdom was completely opposed to regulation as it feared it would damage the attractiveness of London as a financial centre (Cassis 2006, p. 224). The United States, on the other hand, had changed their position. They were against the regulation of the Eurodollar market in the early 1970s, partly because they considered the Eurodollars were not responsible for macroeconomic disturbances (Altamura 2017, p. 95-96).

However, they adopted a different attitude in the late 1970s, as they considered that the important worldwide demand for dollars facilitated by the Euromarket was pulling the supply of dollars (Altamura 2017, p. 199). The American attitude was coherent with the more active position adopted by United States delegates in the Basel Committee about the regulation of country risk. Both Germany and the United States proposed to impose minimum reserve requirements similar to those they had at home in 1979, but the second oil crisis made their proposals lose weight, as they were considered difficult to implement. It also faced fierce opposition from the United Kingdom and Switzerland. France had a rather permissive position towards the Eurodollar markets even though it exerted a very strict state control at home. They did not want to penalise their own banks in the international competition, they preferred a regulation in the form of exchange controls to which most countries were opposed, and they considered that Euromarket regulation was impossible as long as the United Kingdom was not ready to take its part.[18] Japan was pushing the fast expansion of its banks internationally and did not want to stop their successful growth (Katada 2008). At the national level, existing regulations concerned capital ratios, limits to the concentration of risk on a single borrower, or foreign exchange activities, but in the mid to late 1970s, there was no formal limit in the BCBS countries to international lending to specific countries.[19]

Basel Committee members, and banking supervisors in general faced two challenges when discussing country risk: at the micro-level, delineating their responsibilities and those of commercial banks, and at the macro level, delineating their role, which they conceived as primarily micro-focused, from that of central bankers dealing with macroeconomic problems. These two challenges caused much hesitation about whether or not dealing with country risk, and how. The phrase ‘country risk’ is mentioned for the first time at the March 1976 meeting in the records of the BCBS.[20] Blunden (Bank of England), the chairman, explained that Lamfalussy, who was not a member of the Basel Committee but was an economic advisor at the Bank for International Settlements (BIS), the host institution of the Basel Committee, had suggested that he present a BIS paper on the question of total bank borrowings in various countries. Lamfalussy had just arrived at the BIS in January 1976 as economic advisor (Maes 2011, p. 65). He was not a supervisor, but an economist of Keynesian tradition. He had long worked in the private sector at the Banque de Bruxelles, where he became chairman, until the bank suffered heavy losses in foreign exchange operations in 1974, which made him particularly sensible to risks and financial stability (Maes 2011, p. 62-63). At the BIS, Lamfalussy would become a champion of financial stability concerns. In October 1976, the reaction of the Belgian delegate André, from the National Bank of Belgium, to an initial discussion on the question of country risk was that he was not sure that the topic was part of the Committee's mandate.[21] Within the Basel Committee, different opinions existed on the responsibility of supervisors in the field of country risk supervision.

Several members of the BCBS did not think that they were responsible for either risk assessment by banks or for the macroeconomic regulation discussed by other committees and institutions. However, several groupings within the BIS, such as the Euro-currency Standing Committee (ECSC) and a working group chaired by Lamfalussy, were raising prudential concerns when addressing macroeconomic issues in international bank lending. Therefore, the Committee felt that they could not ignore the question of growing risks in international lending that these other groupings were examining.[22]

Three related questions emerged in 1978 in the deliberations of the Basel Committee on country risk: 1) should country risk be considered as a simple manifestation of credit risk or as a specific risk requiring detailed regulations? 2) How important were macroeconomic context and macroeconomic data for supervisors? 3) What were the respective responsibilities of bankers and supervisors in country risk assessment? All three questions dealt with the mandate of the Committee, and beyond this, with the role of supervisors. The first question carried important underlying implications. As explained in the 1978 paper of the secretariat of the BCBS, considering country risk as requiring specific regulations meant that:

> the supervisory authorities in effect take over some of the responsibilities for the banks' country exposure. They would establish a credit rating system for countries and classify loans accordingly. Such a credit rating system would then be used to control the country structure of a bank's loan portfolio, perhaps with exposure limits being set vis-à-vis individual countries in relation to banks' own risk capital.[23]

This option was never seriously considered, however: at the June 1978 meeting, all the delegations supported the first of the two approaches.[24] Indeed, they all agreed on the fact that banks, and not supervisors, should be responsible for risk assessment.[25] This position had important regulatory consequences, because it implied that supervisors would not favour strict regulation. However, some countries, and in particular the United States, were more supportive of a few official measures in the field of country risk.[26]

As for the microeconomic versus macroeconomic dilemma, the issues involved proved more challenging to resolve. At the March 1978 meeting, Schneider from the Federal Banking Supervisory Office (Germany) state that: 'they should always bear in mind that, as supervisors, they had to deal with micro-economic matters,' [27] to which an US delegate replied: 'Mr. Dahl [Federal Reserve] felt that it would be short-sighted to over-emphasise the micro-economic approach to country risk at the expense of the macro-economic approach.' [28] A delegate from the National Bank of Belgium also considered that 'it was certainly part of the job of bank supervisors to monitor the degree to which individual banks' country risk were concentrated.'[29] American members felt particularly concerned at an earlier stage than other members of the Committee, and where more active in the exercise on country risk. The delegates from the Federal Reserve and from the Federal Reserve bank of New York stated that they were trying hard to the define the problem from a banking supervision perspective and were hoping to circulate a paper to the Committee soon.[30]

The Basel Committee wrote a first report on country risk in 1979 and sent it to the governors in October. It stated the preference of the BCBS for approaching country risk as a type of credit risk, and that supervisors' responsibility was to ensure banks were monitoring it properly and that they had adequate information.[31] Approved by the governors, it was sent to supervisors world-wide in November 1979.[32] Stating that country risk had to be considered as a type of credit risk implied that it was a risk that did not require extensive regulations. Its members' justification was that, as supervisors, they were not concerned with macroeconomic regulations, nor were they responsible for banks' risk management. The absence of large financial crises since the war, together with the fact that recent failures had been related to foreign exchange issues and not to country risk, participated to the regulatory blindness to country risk.

III

The articulation between the micro- and the macro-economic dimensions in the supervisory issues in the area of country risk is well illustrated by the contacts the Basel Committee had with another G10 based committee, the Euro-Currency Standing Committee (ECSC). Most initiatives in the field of the macroeconomic risks of countries' indebtedness were taken by Lamfalussy, by the ECSC, or by central bank governors (Maes 2011). In practice, the Basel Committee on Banking Supervision and the Euro-Currency Standing Committee overlapped, and discussions on country risk supervision or regulation dealt with a 'grey area' at the crossroads of micro- and macroeconomic phenomena. At the request of the ECSC, the two committees had a joint meeting on 15 November 1978 to discuss the possible use of prudential techniques to limit the growth of international bank lending.[33] For some countries, such as Germany and the United States, this joint meeting was an attempt to control the growth of the eurocurrency market (Altamura 2017, p. 199).[34]

The joint meeting with the ECSC triggered a division of regulatory labour between the two committees. As Clement shows (Clement 2010), the first mention of the phrase 'macro-prudential' in the records of the BIS dates back to a June 1979 BCBS meeting, when Cooke said that 'micro-economic problems (which were of concern to the Committee) began to merge into macro-economic problems (which were not) at the point where micro-prudential problems became what could be called macro-prudential ones.'[35] For Basel supervisors, as for other regulators of the time, macroprudential issues were a new concern and no clear definition or tools were put forward, although one option often considered (and rejected by Basel Committee members) was the establishment of formal limits to international lending.[36] The ECSC was considered as dealing more with macro-prudential questions, but these questions were only emerging at the time, and it would stay limited in banking regulation until well into the 1990s.[37]

By 1980 it was clear that the international financial system was under severe stress. In April 1980, the committee of the central bank governors of the Group of Ten countries, who were the authority to which the Basel Committee had to report, issued a press communiqué stressing the need to oversee the international situation carefully.[38] It also made clear the Basel Committee on Banking Supervision had to continue its work on country risk exposure. It was decided that Peter Cooke (chairman of the BCBS, Bank of England) would represent the BCBS at the ECSC's meetings.[39] The discussions between the two committees revealed conflicting expertise and mindset and were the result of different specialisations in regulatory responsibilities. Lang from the Bundesbank stated at the February 1981 meeting that:

> it was possible in theory to set limits to responsibilities, the prevention of crises being the responsibility of supervisors and the handling of them that of governments, central banks and perhaps supervisors too. In practice, however, there was likely to be a grey area, since if there were to be a major Euro-market crisis it would probably be triggered off by a series of smaller incidents. In such cases there would be an overlap between the responsibilities of the two Committees.[40]

Moral hazard considerations were an important dimension of the banking supervisors' opinion on international bank lending regulation.[41] In February 1981, Cooke considered that 'indeed, most supervisors would agree that the health of the system sometimes required that the imprudent should pay the penalty for their imprudence.'[42] Basel Committee members, as many supervisors, relied on market mechanisms for ensuring prudence in banking activities, which participated to minimising their involvement in country risk. In a speech given in April 1983 about the now on-going Debt Crisis to the Bankers Association for Foreign Trade, an influential American bankers' association oriented towards international activities, Cooke reaffirmed this approach:

> We fly in the face of the disciplines of the marketplace at our peril. […] The signals which are given through price movements tend, I would suggest, to be more effective regulators in the long term than quantitative limits applied within a framework of unrealistic pricing.[43]

Even if a diversity of views existed within the Basel Committee, members often stated that market mechanisms, and in particular penalty for imprudent banks, were a critical help to their task.

As the possibility of a crisis became clearer, issues of lender of last resort were increasingly discussed at the ECSC, whereas the BCBS had never taken any decision in this area.[44] It had carefully avoided this delicate question when it had agreed on general rules delineating the primary responsibility for the supervision of foreign banks between host and home authorities, in an agreement known as the Concordat (Goodhart 2011, pp. 96-114). In October 1982, Dealtry (secretary of the BCBS, BIS) explained to his colleagues that an ECSC report on liquidity crises affecting banks' foreign establishment had been given to the governors in July, and that Richardson, governor of the Bank of England, and Lamfalussy wanted the report to be kept secret.[45] This announcement caused much concern in the BCBS. The Swiss delegate, for instance, suspected the report was about supporting failing banks, for which he had strong reservations. Even if the details of the report were not known, a disagreement on certain points was considered inevitable. The Basel Committee's work on country risk thus sheds light on the diversity of regulatory perspectives and on the difficult combination of macro-economic and micro-economic approaches at a time when only individual small or medium failures, and no general crises, had occurred for several decades.

IV

The last dimension of the work of the Basel Committee in the field of country risk, and another reason why it did not advocate strict regulation, was the lack of good information. Information was a key issue of the period, because nobody knew enough – neither the banks nor the authorities. When George Blunden (Bank of England), chairman of the Committee, asked in March 1976 if a paper produced by the BIS on total bank borrowings by individual countries would be useful to the Committee, March 1976, Bürger from the Bundesbank answered very favourably, saying that his institution 'was making strenuous efforts to discover the degree of indebtedness incurred by German banks in certain foreign countries.'[46]

The BIS had been collecting data on international banking activities since the 1960s, but these statistics had focused on tracing the development of the eurocurrency market and provided no country detail outside the Group of Ten area. The changes in international banking during the 1970s had reduced their usefulness. It was now considered important to have information on countries outside the Group of Ten, because the geography of indebtedness and risk was changing. In February 1973, the secretary of the OECD van Lennep wrote to the general manager of the BIS at the request of the OECD's Development Assistance Committee, an international forum gathering the most important donor countries for development purposes.[47] Van Lennep suggested the BIS to collect a full country breakdown of the Group of ten banks' external positions. Van Lennep's suggestion was well received by the G10 governors, and the BIS started to collect this new information in 1974. In 1975, it extended coverage to those branches of US banks operating in offshore centres of the Caribbean area (Bahamas, Cayman Islands, Panama) and the Far East (Hong Kong, Singapore).[48] The BIS depended on the goodwill of participating countries to provide the information, but its statistics were considered useful because they were directly based on banks' activities.

A summarised version of the BIS statistics can be found in table 2 for international lending to Latin America and Eastern Europe. As expected, they revealed large claims on Latin American countries, particularly Brazil and Mexico, as well as on the Soviet Union, Poland, Hungary and the GDR. Oil-exporting countries, on the other hand, were large net suppliers of funds to the reporting banks. At end 1976, total claims of G10 banks on Latin America amounted to about $ 48 billions, in which $15.8 billions on Brazil, $14.6 on Mexico, a bit less than $ 3.2 billions on Argentina, and a bit less than $ 3 billions Venezuela.[49] Claims on Eastern Europe, including the USSR, amounted to $23.6 billions, in which $8.3 on the

USSR, a bit more than \$4 billions on Poland, a bit less than \$3 billions on the German Democratic Republic, and about \$2.5 on Hungary.

{please place Table 2 near here}

These statistics were considered as useful for both supervisors and the banking community for three reasons: first, they provided supervisors with information on the joint exposure of reporting banks towards individual countries or groups of countries. Second, they gave an idea of the dependence of the reporting banks on suppliers of funds such as oil-exporting countries. Third, they provided guidance to banks themselves for their credit policies, because they gave an idea about countries' international financial positions, on which little information was otherwise available.[50] However, these statistics had shortcomings: they were not complete, even within the G10 reporting area, and were not homogeneous from one reporting country to another. They did not take into account any possible guarantees and, therefore, did not indicate where the ultimate risk lay. There was no bank versus non-bank breakdown and no maturity breakdown. Finally, obtaining them was slow process, an issue frequently lamented by the banks, who used them for their credit policy.[51]

Attempts to invite commercial banks to share their information failed. In 1977, Arthur Burns, chairman of the Federal Reserve, suggested to create a questionnaire asking banks about their claims on foreign countries with a view to compile the data. It encountered strong opposition by the biggest banks who had no incentive to share their information (Maes 2011). Large banks opposed the project because they did not want to take the risk to share their information while their competitors may refuse to do so. Furthermore, they did not want to undermine the informational advantage they had compared to smaller banks, who were more favourable to the project of Arthur Burns.[52]

In order to have the best information possible, banks used both informal and official ways and relied both on statistics and qualitative information. In early 1981, the BCBS circulated a questionnaire on how banks managed country risk in each country.[53] A subgroup on country risk exposure chaired by Willey from the Federal Reserve Bank of New York was established in February 1981 to analyse the replies to this questionnaire. German banks were said to make great use of the press, particularly the *Institutional Investor*, of data from the World Bank and the BIS, but also of their own network based on consulates, business associates and correspondent banks.[54] The Swiss answer particularly highlighted the importance of informal networks:

> A further important source of information is apparently the personal experience and impressions obtained by bankers when travelling or staying abroad and the business and personal contacts made on such occasions. It is considered important to cultivate relations worldwide, particularly as an aid in assessing the political risk factor. Accordingly regular visits are made to countries with which business relations exist or are being entered into and reports are made on what has been learnt.[55]

Japanese banks sometimes set up their own research teams to inquire into a specific question, while some large US banks started to hire political consultants, paying increasing attention to political factors.[56] Large US banks also had more formalised and ratio-oriented assessment systems, making use of computers in a few cases, whereas smaller banks relied more on informal networks (for an historical overview of the role of information technology in banking, see Bátiz-Lazo and Wood, 2002. On computers and ATMs more particularly, see Bátiz-Lazo 2018). The Willey sub-group stressed the mix of both types of knowledge in a June 1981 report: ‘The systems which banks use to assess country risk have generally been built up over many years through a blend of territorial expertise and analysis of local and international statistics,’ emphasising that even sophisticated assessment systems had no prediction capacity and therefore that 'there [was] no substitute for knowledge of the country concerned.'[57] Finally, rating agencies played a limited role in forecasting the consequences of international bank lending to emerging countries: according to a study of the FDIC, corporate bond ratings of money centre banks did not reveal any deterioration in their financial position in the preceding years to the crisis (FDIC 1997, p. 201-202). This was primarily due to their good profitability coming from international loans, but also to a lack of information (Sy 2003). Either way, the Basel Committee did not address the role of rating agencies in its discussions on country risk.

Within the BCBS, all members agreed on the desirability of having better information. However, they disagreed on what should be done by authorities to improve the situation. The idea of an international central risk office emerged in discussions on country risk, first in March 1979, then more insistently in 1981 and 1982.[58] This idea had already been discussed in the mid-1960s among central bank experts at the BIS, but had been abandoned because of the legal and administrative obstacles such a project raised (Toniolo 2005, p. 469, Schenk 2010, p. 159). The rationale of a risk office was to report all credits to authorities so that the overall financial position of clients was identified, in order to help banks to assess their creditworthiness. The BCBS established a working group in June 1981 to examine the question more thoroughly.[59] The proposal was particularly supported by the Germans, who also supported it at the European Economic Community level, but encountered little enthusiasm otherwise.[60] Most delegates saw the exercise as too ambitious and technically too complicated. In addition, other organisations such as the Euro-currency Standing Committee, the Group of Thirty and the Ditchley Group of Commercial Bankers were trying to improve the data on country risk, and Basel Committee members did not want to engage in another similar exercise.

V

Caught between its refusal to engage with macroeconomic considerations and to take any responsibility for banks' lending decisions, the BCBS was not in an easy position from which to take significant steps, despite the pressing circumstances. During the years 1980-82, it limited itself to defining and refining the concept of country risk and to making a few proposals for its monitoring, but this limited output was the result of disagreements and absence of clear solution and not of lack of interest or involvement in the topic. A lengthy discussion on the question in February 1981 showed a renewed interest for country risk.[61] Aubanel (Bank of France) said that in France, banks had recently become much more active in this area.[62]

The Polish debt situation had turned into a crisis where French banks and German and banks, in particular, were exposed. However, as the international debt crisis started, the question was not about if and how to reduce international lending, but on the contrary about how to ensure that international lending to developing countries would continue, so as to prevent or limit a default (Bartel 2017). This was a radical turn in which banking supervision had a secondary role. The handling of the crisis was now in the hands of governments, the IMF, the BIS, central banks and commercial bankers, and the coming years would be about persuading bankers to continue to provide 'new money' in order to avoid a series of defaults (James 1996, p. 371).

Th severely deteriorated situation of borrowing countries triggered and a much more active role of supervisors and other regulators at the national level. This was particularly the case at the Bank of England, where several assessments of the consequences of a possible default by a major borrowing country were conducted in 1980 under the rather straightforward label 'Apocalypse Now'.[63] In May 1980 an important note on the theme was written in preparation for the now regular meetings on exposure to developing countries.[64] Although quite optimistic, as the note was mostly considering a default by one country only, it showed how authorities now expected a crisis and linked international financial stability and banking supervisory considerations to a much greater extent than in the mid-1970s.

Most of the actions taken by the BCBS in 1981 and 1982 focused on the already mentioned initiatives on information and statistics, and on the drafting of two reports, one for the governors, and the other for commercial banks, drafted between June 1981 and March 1982.[65] Both papers were sent to the governors in April 1982 by Peter Cooke (Bank of England), chairman of the BCBS, who indicated in his letter that: '[The Governors] may feel it is particularly timely that it should become known in the international banking community that country risk and country exposure questions are under discussion amongst those meeting in Basle.'[66]

The 1982 report to banks on country risk was composed of a covering note followed by 12 pages and an annexe clarifying the terminology used.[67] It provided banks with guidance on different elements to take into account when assessing country risk, and on how to determine on what country the real risk lay. In its covering note, it stressed the particular needs of small banks, which did not have assessment systems as sophisticated as the big banks. Overall, the text appeared to be an attempt to spread the principles of prudence within the banking community:

> Any system for control of country exposure should be based on the setting and monitoring of country exposure limits. All banks should have a system for establishing, maintaining and reviewing country limits. Overall exposure limits for each country to which the bank extends or is considering extending credit should be set on prudential grounds and not on marketing grounds.[68]

This step taken by the Committee in 1982 through a report to international banks may seem late and modest in retrospect, but has to be seen in the light of the fact that, by 1982, international lending had reached a political dimension that far exceeded banking supervision capacities and responsibilities. The situation was now handled through diplomatic channels. Internal divisions about how to handle the problem as well as the microeconomic focus of banking supervision led the Committee to formulate only general principles, principles which recommended that banks follow a prudent line of behaviour. At the end of 1982, the Basel Committee's work focused on the treatment of rescheduled international loans from a supervisory perspective, which included the provisioning and dividend policies, and was linked to capital adequacy issues.[69]

The crisis had accelerated in August 1982 after the Mexican finance minister had informed the United States and the IMF that Mexican reserves were exhausted, and that Mexico could no longer service its debt. The BIS and the Federal Reserve acted quickly to contain the crisis, but the longer-term response was provided by the IMF which established linkages between the financial community, the indebted countries, and central banks (James 1996, p. 367). However, if Mexico still appeared as singular case in August 1982, Argentina and Brazil experienced similar crises a few weeks later, and were followed by many other countries. In the French case, by the end of 1984 the 35 biggest banks were exposed for about FF 200 billions to 35 to 40 countries whose debt had be rescheduled by the end of 1984, which amounted to 9 per cent of total international bank lending to these countries.[70] The top six countries to which French banks were exposed were at end 1984, by order of importance: Brazil, Mexico, Venezuela, Argentina, Nigeria, Poland, and Ivory Coast.[71] The debt situation would weigh on banks' balance sheets and policy throughout the decade, and would have dramatic social consequences in the indebted countries.

VI

Between 1976 and 1982, the BCBS spent a considerable amount of time discussing country risk in bank lending and related issues. However, did not want to take responsibility for banks' risk management. Apart from American delegates, the pressure for really engaging with the topic often came from outside the Committee: in particular, Lamfalussy from the BIS and central bank governors urged them to work on country risk thoroughly. However, when asked to think about prudential measures to limit international lending growth, the BCBS answered negatively. The microfocus of banking supervision led Basel banking supervisors to place much faith in market mechanisms to stabilise the situation and avoid moral hazard issues at the same time. On a more political level, the hesitant response of the Committee to country risk issues reflected the impossibility of securing an agreement on international bank lending regulation within the G10 authorities. In addition, neither the banks nor the authorities wanted to take any serious steps without clear information, and this information was lacking. All in all, the authorities were poorly equipped to appreciate international banking activities on a global level. Country risk appeared as an impasse for banking supervision, and the Basel Committee, even if it did produce some expertise on the topic, contributed to the general lack of regulatory response to widespread country risk. The risks run by the international financial system were realised well in advance, but regulators could not decide on a course of action to take to improve the situation, mostly because central banks and international organisations relied on commercial banks for the recycling mechanism.

One of the reasons why the BCBS refused to regulate country risk was that supervisors considered that banking supervision should be limited to microeconomic matters. This feature of the supervisory system is essential for two reasons. First, because it was to remain an issue for years to come: it is only around 2000 that financial stability and the macroprudential approach really became significant regulatory policies.[72] Second, because microprudential banking supervision continued to grow steadily after the Debt Crisis and became an important part of the political economy of global finance. These characteristics and their implications for financial crises prevention are too often overlooked in the literature on the history of banking regulation.

If it took a long time for macroprudential financial stability to become a major element of the regulatory system, the International Debt Crisis and country risk issues did play a role in the later history of the Basel Committee. Not only did it become central to supervisors' ordinary practice at the national level as rescheduling operations proliferated in the 1980s, but it also induced a sharp reduction of international lending activities, apart from the flows organised by the IMF to prevent defaults, which pushed banks towards securitisation.[73] Most importantly, it is considered the indirect origin of the Basel agreement on capital adequacy, as the US Congress pressed American authorities to reinforce supervisory standards after the crisis (see also Wood 2005).[74] The famous agreement, known as Basel 1, also incorporated some country risk considerations in its system of risk weighting. However, it did not change the microfocus of banking supervision: instead, the crisis led to a focus on banks' capital, which became the most crucial regulatory matter of the 1980s and the following decades (Kobrak 2015, Drach 2019). Studying the years preceding the crisis sheds light on the challenges that such a focus raises for the surveillance of the international financial system as a whole, and why Basel supervisors were against regulation in the late 1970s.

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TABLES

Table 1. Estimated flows between the BIS reporting banks, non-OPEC LDCs and Eastern Europe, 1974-1982. In billions of US dollars at constant end-of-quarter exchange rates.

Gross borrowings	Stocks at end 1973	Flows 1974-77 yearly averages	Stocks at end 1977	Flows 1978	Flows 1979	Flows 1980	Flows 1981	Flows 1982	Stocks at end-1982
Non-OPEC LDCs	32.0	14.3	97.2	22.4	35.3	38.9	39.9	19.7	246.9
Eastern Europe	9.5	5.1	38.3	5.7	7.1	6.8	4.8	-4.7	53.3

Source: BIS 1982-1983 annual report, p. 120.

Table 2. External position in domestic and foreign currency of banks in Group of Ten countries and Switzerland to the most indebted countries in Latin America and Eastern Europe.
Amounts in millions of US dollars, end March 1976.

Vis-à-vis	**Assets**	**Vis-à-vis**	**Assets**
Latin America		Eastern Europe and Soviet Union	
Argentina	3.187	Bulgaria	1.682
Brazil	15.837	Germany (GDR)	2.945
Mexico	14.599	Hungary	2.565
Peru	2.477	Poland	4.178
Venezuela	2.959	Soviet Union	8.302
Total	48.215	Total	23.591

Source: BISA, 1.3a(3) 1976/5, 'The BIS Statistics on International Banking,' H.W. Mayer, 24 September 1976.

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[1] At that time, the Basel Committee on Banking Supervision was called the Committee on Banking Regulation and Supervisory Practices (CBRSP). For the purpose of clarity, only the name Basle Committee on Banking Supervision (BCBS) will be used in this article.

2 A substantial part of this section is devoted to maturity transformations in wholesale international markets.

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44 BFA, 1749200912/305, Twenty-first meeting of the BCBS, 26 and 27 Feb. 1981.

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