

Herstatt, Franklin National and the founding of the Committee

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The immediate trigger for the Committee's founding was a series of bank failures in 1974 that exposed the gaps in the supervision of internationally active banks. On 26 June 1974, the German Federal Banking Supervisory Office withdrew the licence of Bankhaus I.D. Herstatt in Cologne, a medium-sized private bank that had built up large and loss-making positions in foreign exchange. The closure took place at the end of the German business day, at a time when counterparties of Herstatt had already paid Deutsche Mark to the bank in Frankfurt but had not yet received the US dollars due to them in New York. Those payments were never made.¹

The loss that counterparties suffered in this way gave its name to a category of risk that the financial world still calls "Herstatt risk", namely the settlement risk that arises when the two legs of a foreign exchange transaction are settled in different time zones. The failure caused disruption in the New York payment system and a temporary loss of confidence in the interbank market. It showed that the closure of a single bank by a national supervisor could have consequences far beyond its own jurisdiction.² Decades later, the creation of the CLS Bank in 2002, which settles foreign exchange transactions on a payment-versus-payment basis, can be traced back to the lessons of that June afternoon.

Only a few months later, in October 1974, the Franklin National Bank of New York, then one of the largest banks in the United States, was declared insolvent. Its failure resulted in part from speculative foreign exchange dealings and was connected with the Italian financier Michele Sindona, who controlled the bank. The Federal Reserve had supported Franklin National with large loans before its failure. The episode demonstrated how interconnected banks on both sides of the Atlantic had become.³ The failure of the Israel-British Bank in London in the same year added a further

example of a cross-border collapse in which it was unclear which authority bore responsibility for which part of the group.

The central bank governors of the Group of Ten responded at the end of 1974. Meeting at the Bank for International Settlements, they decided to establish a standing committee of supervisors, which was initially named the Committee on Banking Regulations and Supervisory Practices. Its first meeting, held in February 1975, was chaired by George Blunden of the Bank of England.⁴ The members were the central banks and, where they were separate, the supervisory authorities of the G10 countries together with Switzerland and Luxembourg. The choice of Basel followed naturally from the fact that the governors already met there every month and that the Bank could provide a secretariat.

In its early years, the Committee served mainly as a forum for the exchange of information among supervisors. Its members came from very different supervisory traditions. The Bank of England relied on informal moral suasion and the personal authority of the Governor, whereas the United States supervised banks through several federal and state agencies and Germany possessed a specialised supervisory office with statutory powers. The idea of harmonising capital rules was far from the minds of the founders. They wanted to close the gaps that had allowed internationally active banks to escape effective supervision and to ensure that no foreign establishment of a bank remained outside the reach of a supervisor.⁵

1 Notes

1. On the Herstatt failure, see the account in Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years 1974–1997* (Cambridge University Press, 2011), chapter 2; the closure by the Bundesaufsichtsamt für das Kreditwesen on 26 June 1974 is well documented. To be verified. ↩
2. The term "Herstatt risk" for foreign exchange settlement risk is used in BIS publications, for example *Committee on Payment and Settlement Systems, Settlement Risk in Foreign Exchange Transactions* (Allsopp Report, March 1996). To be verified. ↩
3. On Franklin National Bank, declared insolvent on 8 October 1974, see Goodhart (2011), chapter 2, and the literature on the Sindona affair. Date to be verified. ↩
4. Press communiqué of the G10 central bank governors of February 1975 on the establishment of the Committee; first meeting in February 1975 under the chairmanship of George Blunden. See Goodhart (2011),

chapter 3, and the "History of the Basel Committee" on the BIS website.
To be verified. ↩

5. On the different supervisory cultures of the founding members, see Goodhart (2011), chapters 1 and 3, and Kapstein, *Governing the Global Economy: International Finance and the State* (Harvard University Press, 1994). To be verified. ↩

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