Summer in The City: The 1974 international banking crisis in London and its implications for regulatory reform[1]

Catherine R. Schenk
University of Glasgow
November 2011
Catherine.schenk@gla.ac.uk

The relationship between regulators and the regulated in financial services has attracted considerable academic attention, partly because banking systems operate differently from other markets. The systemic macroeconomic importance of national banking systems makes a strong case for prudential supervision by an outside body, but information asymmetry in financial services, and the importance of reputation and private information as key bank assets all complicate the ability to engage in transparent prudential supervision. The potential for regulatory capture is particularly strong between central banks and the banking system because of the close connections that are required to supervise complex financial transactions where highly specialized knowledge is needed for identification and diagnosis of problems.[2] In many financial markets a model of self-regulation has therefore developed in response to an assessment that 'the market knows its business best'.[3] A further incentive for self-regulation is the vulnerability of otherwise sound banks to rogue business by a small number of institutions, so it is in the interests of well managed banks to ensure that others operate to the same high standards; systemic vulnerability increases incentives for market leaders to impose discipline. Finally, trust is an important feature to ensure compliance with supervisory regulations since the information necessary for prudential supervision is often market sensitive, and the private information on investment portfolios and strategies is a valuable asset for banks. The relationship between banks and supervisors/regulators is thus complex and prone to lapses.

The difficulties of prudential supervision are magnified on the international level. Because national banking systems are fundamental to macroeconomic policy, their supervision is a jealously guarded prerogative of national regulators. However, the highly integrated nature of national banking systems and the vulnerability to cross-border contagion in the context of globalised financial markets provides a strong rationale for some form of multilateral oversight. Because rules incur costs for banks, rules may also need to be coordinated to avoid regulatory competition (to the bottom) which would leave the global system vulnerable by eroding the competitiveness of jurisdictions where banks are subject to effective prudent supervision. Since 1975, this multilateral role has rested primarily with the Basel Committee on Banking Supervision, which reports to the central bank governors of member countries of the Bank for International Settlements. It has no supranational authority itself, but rather issues guidance on supervisory standards and best practice to which national institutions can voluntarily agree to comply. Compliance is not a formal requirement of membership, but from the early 1990s there was increasing moral pressure to adhere to the Basel Committee standards of capital adequacy as a 'seal of approval' of the resilience of a nation's banking system. The rules were developed through discussion with banks, industry groups and supervisors so they are in a sense a negotiated set of standards agreed with the market. This encourages compliance and shares insider knowledge of working arrangements, but also leads to the threat of capture of the regulatory process by the banks. In addition to capital adequacy for banks, the Committee issues standards for national banking supervision as a benchmark for national regulatory bodies.[4] The adoption of these standards as a guide for the IMF and World Bank's Financial Sector Assessment Program increases the pressure for compliance, particularly for developing countries.

Between 1965 and 1982 there were substantial challenges to the governance structures of international banks as they coped with financial innovation and a huge expansion of off-shore banking in an inflationary environment with new forms of exchange rate risk. From 1968-73, rising international liquidity, the development of the Eurodollar market, deregulation of capital flows, technological advances in information systems, the rise of new offshore international financial centres in the Caribbean and East Asia, rapid international expansion of banks with a variety of governance structures (branches, subsidiaries, cross-shareholding and bank consortia) all contributed to the growth and intensification of international banking. Into this expansionary and optimistic environment, the OPEC price shock of October 1973, coming only six months after the US dollar exchange rate was floated (for the first time since 1933), prompted a quick reversal of market exuberance in the third quarter of 1973 leaving many institutions exposed to severe fluctuations in the dollar exchange rate. This context shared many characteristics of the 2007 crisis;

accelerated international financial innovation, liquid markets, commodity price shocks, property market boom/bust, market exuberance.

This paper examines the 'near miss' global banking crisis in the summer of 1974 when a series of bank collapses shocked the international banking community. Although in the end losses were relatively small, systemic effects were limited and the ensuing credit contraction was short-lived, the episode had a seminal impact on international banking system. It provided a wake-up call to national regulators and prompted the amendment of Banking Acts in the UK, USA and Germany to close gaps in national banking supervision.[5] More importantly, the G10 central bankers responded by launching the Basel Committee on Banking Supervision at the beginning of 1975. The outcome of the 'near miss' of 1974 was greater reflection on prudential supervision structures nationally and the identification of a gap between supervising authorities for international banks that prompted somewhat reluctant consideration of greater international coordination. Franklin National Bank exposed the US banking system's vulnerability to fraud through inter-linked international banks and the dangers of slow response to evidence of weaknesses in national banks. Lloyds Lugano prompted the Bank of England to reconsider its supervisory myopia over the operations of overseas branches of UK banks. The collapse of Herstatt raised the spectre of a small bank with a bad reputation disrupting confidence in fragile markets. It clearly revealed the interdependent nature of national markets and regulations; in this case the vulnerability of London to lapses in prudential supervision in Germany. The collapse of the Israel-British Bank led to a tug of war over who was responsible for subsidiaries operating in foreign markets. Together these four episodes in the Summer of 1974 drove changes in national and international approaches to prudential supervision. While the Herstatt collapse is the most well-known and is usually credited with the launch of the Basel Committee, the archive record shows that in London the Lugano debacle and the collapse of IBB were at least as influential in galvanising change and that they had greater importance in the agenda of the Basel Committee than the Herstatt and FNB.[6]

Rash of Failures

In mid-1974, a sharp monetary expansion and lax regulation prompted a wave of failures across the so-called 'fringe banking' sector in London.[7] Property lending based on short-term money market borrowing was at the heart of the liquidity crisis that struck the system in the middle of 1974.[8] When the real estate boom broke in the autumn of 1973, many institutions were left illiquid. London money market rates rose sharply in February 1974 from less than 0.5% to almost 2.5%, and then soared to 6% in June. Many institutions caught out had been hire purchase companies that had diversified into property lending. Most of the banks that failed were smaller independent concerns but the commercial banks were still drawn into the resolution of the crisis through the now famous 'lifeboat' scheme skippered by the Bank of England. The danger was contagion from the wholesale to the retail banking market in a way that would affect public confidence, liquidity and the monetary system. Although generally not individually large, the Bank of England considered the systemic threat great enough to warrant a range of solutions extending from collective bail-out, restructuring and emergency loans to direct acquisition of banks to forestall wider panic. The perceived self-interest of other banks in preventing a general bank run ensured their involvement.

The joint Bank of England-commercial bank Control Committee was established to deal with banks and other financial institutions requiring support and directed a range of operations including bails-out to allow them to resume normal trading (Bowmaker, Keyser Ullman, Medens Trust), managed take-overs (Mercantile Credit– Barclays), voluntary liquidation (London and County Securities Ltd.) or receivership (First Maryland, Burston Finance). Other institutions were supported by the Bank of England at the Bank's sole risk. Several of these had been primarily engaged in lucrative instalment finance/hire purchase lending but were tempted into the property market during the boom leaving them illiquid. No insolvent institutions were supported. The support of the Control Committee allowed them to divest themselves of this aspect and return to their core business. Operation 'Lifeboat' as it became known is usually viewed as a success insofar as it prevented contagion to the domestic retail market and thus avoided the liquidity and monetary consequences of a potentially major bank run.

As we shall see, this model of shared official and industry responsibility for national insolvencies was echoed in New York and in Germany, although with different institutional structures. The ad hoc, but effective Lifeboat solution in London was facilitated by the small number of large commercial banks in the UK, which made collective action easier to launch and then manage. In the USA, by contrast, the FDIC engaged the participation of the much larger number of banks through subscriptions. The FDIC then acted as principal in bank rescues. In both cases the central bank was participating partner but did not assume full lender of last resort functions. In Germany, legal constraints on the support that could be offered by the Bundesbank led to the creation of a separate institution with capital from the Bundesbank and large national banks to provide liquidity to banks in short term difficulties.

While the 1974 secondary banking crisis in London showed that domestic banking systems in various constituencies were vulnerable to lax supervision, highly leveraged real estate lending and imprudent trading, the international banking environment faced even more severe external environmental challenges and internal complexity. Internationalisation of banking exploded from the late 1960s in response to the increased demand for services by multinational enterprise, the differential regulatory environment in international banking centres and financial innovation. The Eurodollar market offered unsupervised business opportunities to a range of financial institutions and drew a huge number of new actors into the market. Concerns about the ethics and reliability of some of these institutions began to multiply in the early 1970s.

Partly this global activity spread to new offshore centres such as Guernsey, Isle of Man and later the Cayman Islands. After a scandal over the Bank of Sark (a fraud vehicle for American Philip M. Williams), Guernsey introduced legislation to set constraints on companies establishing themselves as 'banks' in the late 1960s so that only companies clearly associated with well-known and respectably established banking, insurance or trust companies could engage in banking. In early 1972, a rush of financial institutions registered in Tortola in the British Virgin Islands, several of which appeared to have weak or even fraudulent foundations. One of the most prominent of these was the Inter-Cambio International SA registered in Panama with links to the Sovereign Trust Company registered in Prince Edward Island, and under surveillance by Canadian authorities.[9] Rather belatedly these centres established banking registration systems to raise the quality of institution that could enter the market. But the main casualties of illegal trading in the 1970s were banks in the large US and European financial centres.[10]

Herstatt Bank

The I.W. Herstatt Bankhaus in Germany was the largest and most famous victim of the summer (liabilities of $840 million against assets of $380 million[11]) and posed a systemic threat, mainly because of the way the Bundesbank handled the crisis. It is generally credited with the launch of the Basel Committee and certainly influenced its terms of reference, which included the design of an 'early warning system'. As we shall see, however, this proposal was quickly dropped by the Basel Committee under its chair George Blunden of the Bank of England, and it turned instead to resolving issues raised by the Lloyds Lugano and IBB cases.

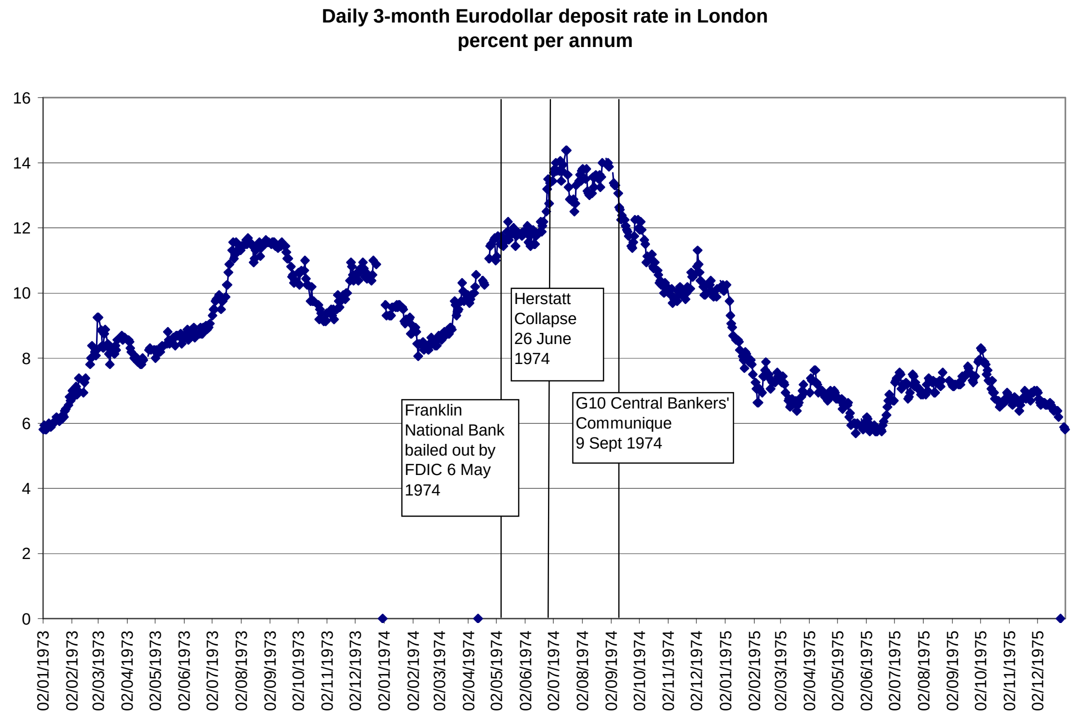
The Herstatt bank was majority owned by Hans Gerling, head of an insurance company (who held 81.4% of shares) and had over 50,000 customers and assets of more than DM2 billion, placing it 89th out of the top 100 largest banks in Germany.[12] Rumours about overtrading had begun in the summer of 1973, a year before the final collapse. Formal returns to the German Supervisory Office (Bundesaufsichtsamt) did not require reporting of forward exchange commitments so direct knowledge of the positions was not available to the relevant national supervisor. The Bank of England claimed credit for warning the German authorities of the bank's over-trading in foreign exchange, after which Iwan Herstatt (the founder of the eponymous bank) was questioned, but successfully reassured the supervisors that 'all was in order'. [13] A repeat of these assurances was sought in the Autumn of 1973 and again in December. The Herstatt also attracted the attention of the Bank of England in the Autumn of 1973 when Richard Hallett spoke to Herstatt about over-trading and excess positions in the Eurodollar market.[14] Herstatt's explanation to the German authorities was that although there was a large forward book, this was 'because they had very important Ruhr customers who had entered into large forward contracts with the Bank, which the Bank, in turn, had covered in the market. Consequently, their forward book, though large did not leave them with exposed positions'.[15]

In mid-Feburary 1974 Stauch of the German Supervisory Office wrote to Hestatt's auditors requesting a close examination of the forward book and they gave Herstatt a clean bill of health at the end of March.[16] The Supervisory Office was reassured until the end April returns showed that the Cologne parent of Herstatt had greatly increased its claims on the Luxembourg subsidiary, bringing them to nearly DM 1 milliard. Gerling (the main shareholder) was told by the Supervisory Office to investigate and he wrote to Iwan Herstatt in early May asking for an explanation. This was not forthcoming until the end of the month when Herstatt gave a further reassurance that all was in order. Gerling was not satisfied and the full position was clear only in the third week of June 1974 when reports revealed DM470 million in losses against capital and reserves of only DM44 million (actual losses were much higher). Interestingly, on 19 June Chancellor Schmidt advised the UK Prime Minister that three large German banks had decided not to increase their position in the Eurodollar market, which threatened to rock confidence in the market.[17] Herstatt's losses arose from short positions (mainly against the US dollar) in forward contracts ranging up to 4 years, but most within the next 12 months.[18] At meetings with the Supervisory Office the Landeszentralbank in Dusseldorf, and the 3 Grossbanken (Deutschebank, Commerzbank, Dresdnerbank Gerling offered to pay off the loss himself over 15 years but the Grossbanken would not agree to act as a guarantor for Gerling for such a long period. The banks were not convinced that the total losses had yet been determined and Gerling's wealth depended on a range of companies that were not fully transparent themselves ('closed companies'). At this point Gerling withdrew his personal undertaking and the Supervisory Office had to 'put up Herstatt's shutters'.[19] Despite the chaos caused in the international financial markets by the timing of the closure while the New York market was still open, the Bundesbank said the decision had nothing to do with them and was in accordance with the law. Once the trustee was persuaded that the bank could not be rescued he was legally bound to close it immediately at close of business in Germany

The Herstatt was closed at 16:30 Germany time or 10:30 New York time, having taken on claims in European time but not yet having made US dollar transfers to counterparties in New York time, leaving the correspondent banks out of pocket. This gave rise to the term 'Herstatt Risk' which is the risk of settling foreign exchange transactions across time-zones. The bank collapsed in the midst of the FNB crisis (which had already unsettled the markets) and fears about further collapses led to the suspension of CHIPS (clearing house interbank payments system) settlement and contracted the efficiency of interbank settlement for months afterward.[20] Like other banks, Herstatt was heavily involved in the foreign exchange market and had accumulated significant losses as the USD exchange rate fluctuated wildly from the last quarter of 1973.[21] The Herstatt failure prompted withdrawals from commercial banks in Germany, a sharp increase in Eurodollar market interest rates, and a contraction in international banking activity as banks around the world repatriated their assets.[22]

Eurocurrency markets were disrupted as confidence in smaller banks eroded. Oil producers and others preferred to deal with larger banks and so smaller banks had to raise interest rates to attract deposits, thus ‘bidding the market up’.[23] In the aftermath, the Governor of the Bank of England urged the Chancellor of the Exchequer to discourage Chancellor Schmidt from making any derogatory remarks about the Eurocurrency markets that might exacerbate their unsettled state and that ‘any future troubles in the German banking system should be handled in such a way as not to unsettle international markets’.[24] Japanese banks in London were instructed in mid-July not to pay a premium for Eurodollar deposits to try to contain the rate inflation.[25]

Figure 1 shows the daily 3-month Eurodollar deposit rate in London from 1973-1975.



Small banks were also squeezed out of foreign exchange business; Slater Walker complained to the Bank of England that they might be forced into temporary default because of difficulty in getting into the market. The Bank of England generously offered to help through the Discount Office if necessary, and this advice was to be offered to other banks in similar circumstances.[26] Charterhouse Japhet also found itself squeezed out of the foreign exchange market; removed from dealing lists or limits reduced.[27] They asked Blunden to reassure markets by 'clear evidence to the banking community that we are looking more closely at banks' business and examining their figures more frequently'. Blunden replied that such evidence would be forthcoming 'in the next month or two' and 'asked him [Wells] to ensure that if, when we asked for more information, there was resistance from other Accepting Houses, he would ensure that in the Committee Japhets supported our request. He promised to do this.' The formal letter to banks was finally forthcoming six months later.

International clearing was also affected. On 1 July 1974 clearing banks in New York introduced a 'recall' provision whereby they reserved the right to recall funds transferred to correspondent banks at 10am the day following issue. At this time the amount of foreign clearing in New York had reached about $60 billion per day, leaving a large exposure, especially in the wake of the Herstatt collapse. At first the New York banks delayed transfers until they were matched by in-payments but this virtually froze the clearing process, which was extended until 1am on three consecutive days.[28] The number of recalls was low (2-3 per day, mainly on account of small banks) but the Committee of London Clearing Bankers protested that this led to damaging uncertainty in London.[29] Swiss and Dutch bankers were also vociferous objectors, but London was the world's second largest international clearer so the effects were greatest there. In effect the provision meant that international payments conducted through the CHIPS clearing system were not final until the business day following the date on which the payment order was released (CHIPS had been introduced in April 1970).

London banks were mainly left unscathed by the Herstatt collapse directly and the main arena for creditors was New York. Hill Samuel complained bitterly about their

$21 million losses and tried through the German embassy in London as well as the Bundesbank to get their money refunded (to the embarrassment of the Bank of England and fellow merchant banks). Their problem was typical: the timing of the closure of Herstatt caught Hill Samuel OHG (their German office) between two sides of a spot transaction of DM54m paid to Herstatt before the counterpart of $21m could be received in New York. When Hill Samuel complained at the Bank of England, Hallett ‘expressed some surprise at the size of this deal with Herstatt whose name had been suspect in London for some time’.[30] Clearly market gossip was intended to encourage caveat emptor. Moscow Norodny Bank was the most affected but it appeared to suffer no ill effects since it was backed by its owners, the Russian Central Bank. Details are presented in Table 1.

Table 1: Losses of London banks to Herstatt (USD million)

Williams and Glyns	$9m deposit
Chase Manhattan	$5m swap
Moscow Norodny	$365m swaps
Union Bank of Switzerland	$25m swap
Hill Samuel	$21m swap
United Bank of Kuwait	$190m swap
First Wisconsin National Bank of Milwaukee	$10m swap
Antony Gibbs	$1.25m swap

BoE 349A/2 Memo JLS 27 June 1974 and 29 July 1974.

Herstatt’s main correspondent bank was Chase Manhattan Bank in New York, which was caught with about $620m of transfers due to customers on account of Herstatt.[31] Chase froze the Herstatt account (with about $156m in it) refusing to honour claims on the bank. Among more than 30 banks, claimants to the account included Morgan Guarantee ($13m), a Swiss subsidiary of Seattle-First ($42.5m), Hesse-Newman of Germany ($39.7m), Citibank ($10m), Svenska Handelsbanken ($7m), Asian-Euro American Bank of Singapore ($1m). Chase itself had only a $5m claim of its own on Herstatt funds. Some of the deals were spot exchange and some were forward contracts, which complicated the legality of settlement. In Cologne on 17 December about 3000 creditors appeared to make claims on Herstatt. The German settlement allowed for private customers to retrieve 65% of their claims, foreign banks to retrieve 55% of their claims and German banks only 45% on the basis that the German banking system was in some sense more responsible for the international consequences of the collapse, although the rationale for this was unclear.

In New York, claimants were also designated by domicile as well as by type of contract (spot transactions gaining a larger share of their claim) in a graduated scale of 9 categories of claimant, ending with German creditors who would receive 1% of their claims in New York. This provoked resentment among German banks who sought to make distinction only on whether the frozen transaction was spot or forward. Finally, agreement was resolved among 34 creditors in New York in late February 1975 with a range of quota from 58.78% to 86% based primarily on the nature of contract with the proviso that US banks would not need to seek funds from Germany, but could access their shares more quickly from the funds at Chase. In early June 1976 $176.5m was paid out to claimants in New York, described by a participant as 'an extraordinary financial and legal achievement' that provided that the case was not settled by law courts but through mutual negotiation, thus overcoming the obstacle of dual jurisdiction over international assets.

In Germany, from January 1974 the Bundesbank had guaranteed deposits up to DM20,000 per person, so the collapse cost the Bundesbank about DM100m to compensate depositors. In Germany, Local Authorities in the Cologne area, Carnival Clubs and Catholic churches were the main losers of deposits.[32] In September 1974, the Bundesbank set up the Luquiditate-Konsortialbank (LiKoBank) 'to assist otherwise healthy banks which seem likely to get into liquidity difficulties, the aim being to avoid a loss of confidence in the German banking system as a whole'.[33] The LiKoBank was a joint venture with DM1 billion in capital (DM250m paid up) shared between the Bundesbank (30%), German Banks' Association (30% and the Savings Banks' Association (26.5%) with smaller associations sharing the remaining 13.5%. It used the personnel, offices and facilities of the Export Credit Company (AK) and comprised a nine member Management Board and a five person Credit Committee. The LiKoBank was a limited liability company and represented a more permanent precautionary response to provide emergency liquidity than the Lifeboat in London.

Its aim was to enhance confidence in the event of a banking collapse to prevent loss of confidence; to be a lender of last resort. This solution arose because the Bundesbank cannot legally provide credit except against good security (rediscounting bonds or granting advances against collateral) so it required a separate but linked vehicle that could issue bills against pledged assets of banks in trouble that would be discounted by the Bundesbank. By 1978 they had only been involved in one public rescue (DM300m for Helaba support fund in December 1976) but had also undertaken smaller and less public support.

Despite the limited direct effects, the reaction to the Herstatt crisis in London was fierce disappointment at the timing of the closure of the bank and its impact in London and on the markets generally. This episode clearly exposed the vulnerability of London markets to the actions of supervisors in other jurisdictions through the global capital market. The Basel Committee was therefore tasked 'to give particular attention to the need for an early warning system' to pre-empt a repeat of the 1974 crisis by sharing information on risk. However, the Committee members quickly dismissed the proposal for an 'early warning system' and focussed instead on sharing best practice in regulation and supervision and establishing the division of responsibility between home and host regulatory authorities to eliminate apparent gaps in supervision of international banks. George Blunden remarked at the first meeting that 'it was not intended that the Committee should engage in far-fetched attempts to harmonise countries' supervisory techniques'.[34] His report to the Governors in June 1975 made it clear that there was 'no question of the Committee producing a great new international early warning system'[35] and that any early warning mechanism must be based on national systems. Instead, the Committee broadly agreed that sharing market rumours could be useful for early warning, but would need to be voluntary and based on a confidential and trusting relationship among central bankers. This was clearly a very limited initiative that moved very little from the status quo ante where banks' reputation was informally assessed by peers based on subjective evidence. There were also mixed views in the committee about the efficacy and ethics of exchanging market gossip, with the Japanese, Belgians and Swiss particularly averse to accepting that any positive action could be taken by central banks on the basis of such rumour. The impact of the Herstatt collapse on global liquidity was over by the time the Committee convened for the first time in early 1975 and the members' attention was drawn more toward the structural lacunae in the supervision of international banks governance of the foreign exchange markets than improving the flow of information on individual banks between jurisdictions.

Franklin National Bank

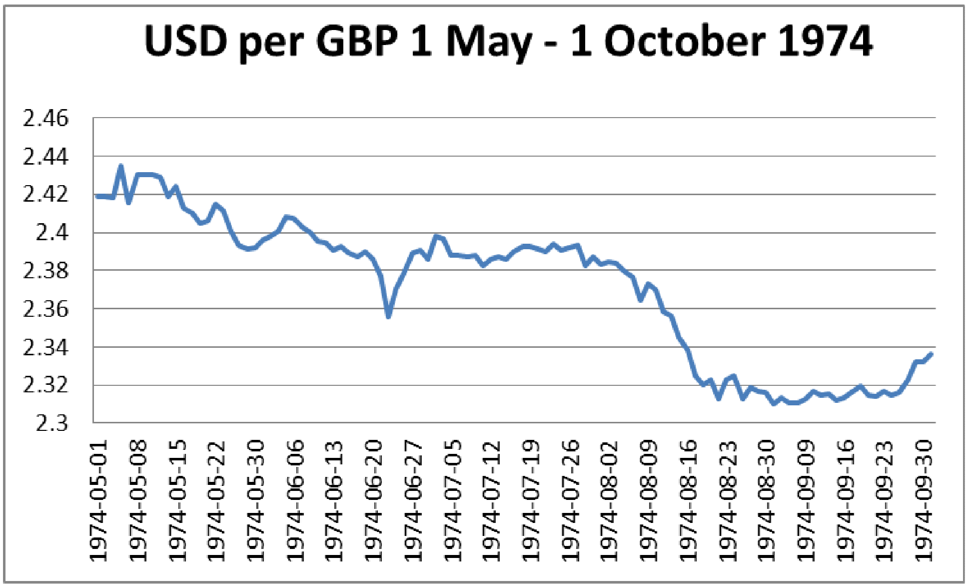
The other bank usually credited with the launch of the Basel Committee is the Franklin National Bank (FNB). After struggling (with FDIC support) from May 1974 the FNB in the USA was finally declared insolvent on 8 October 1974. The bank was controlled by Michele Sindona (an Italian banker linked to the Mafia) and opened two foreign branches (London and Nassau) to launch itself into the international banking arena between 1969 and 1974, just at the time of increasing risk in international exchange markets. The bank's failure was only announced after five months of rescue plans beginning in early May when it became clear that the bank was on the brink of announcing huge foreign exchange losses.[36] Between November 1973 and May 1974 the bank had built up its net short position against the dollar from \$62.6 million to \$232.6 million. This speculation was unauthorised but tacitly facilitated by Peter Shaddick (executive vice chairman and head of the international division) who was hired specifically to develop an aggressive foreign exchange trading position, and Carlo Bordoni (director of Franklin New York Corporation). Despite urging from the Office of the Comptroller of the Currency after inspections in December 1972, the bank was slow to introduce trading limits for dealers and then was lax in enforcing them.[37] To cover mounting losses, dealers engaged in supposedly profitable contracts with Sindona-owned banks in Milan and Zurich at non-market prices to fix the books. As losses mounted, doubts emerged in the market about the bank's liquidity and the Fed's rejection of an acquisition proposal at the start of May 1974 (on the grounds that the bank's earnings were too low) prompted a withdrawal of deposits and more difficulty borrowing on the interbank market. Soon after, the London branch reported that NatWest was questioning the £40-60m per day clearing through the bank's sterling accounts, exposing unauthorised trading and substantial losses. The stock price plummeted, share trading was suspended on 10 May and dividends were stopped, prompting fears of a bank run, but the FNB continued to trade with official support. During May 1974 the FNB borrowed \$780m from the Fed discount window, climbing to \$1.2 billion by the end of the month. The bank continued with further support arranged by the Comptroller of the Currency along with the New York Clearing House banks, who collectively contributed a $600 million loan arrangement.[38]

In 1973, loans by FNB's foreign branches (mainly Eurodollar syndications) accounted for about 20% of total loans.[39] Spero notes that the loans themselves were of good quality, but the narrow spread between the LIBOR (the cost of the funds loaned by FNB) and the Eurodollar lending rate meant that they were not very profitable. During 1973 and early 1974, the LIBOR-Eurodollar spread narrowed significantly (to 3/8 – ½% in the first half of 1974) squeezing profits. The leaders of major loan syndicates earned a management fee on top of this margin which increased the profitability of the loans for them, but smaller banks were more vulnerable as margins shrank. Maturity transformation was a source of further weakness. Almost 75% of FNB's international loans assets eventually sold to the FDIC had a maturity over 3 years based on very short term borrowing of up to 90 days. In the wake of the 1974 Summer crisis, the London banking system as a whole reassessed maturity distribution and syndication. During the first half of 1974 the average size of individual syndicated loans was $78m, but this fell to $41m in the second half of the year after the FNB and Herstatt collapses. The maturity of syndicated loans also contracted after mid-1974 from almost 9 years to less than 6 years by the first half of 1975.[40]

Within a month of the suspension of share trading, NatWest was one of the first banks pushed reluctantly into the frame for a take-over of FNB supported by the FDIC. In mid June 1974, the Fed contacted the Bank of England with a proposed deal that Natwest and Bank of New York would jointly take over the FNB (80%-20% respectively) for about $100-200m depending on FDIC support. Natwest claimed that this plan originated with the BNY rather than themselves and that they were lukewarm about it.[41] The FDIC was very eager to attract a buyer quickly as the FNB bled deposits through the summer of 1974 and Wille, the Chairman of the FIDC, asked the Bank of England to approach Barclays on their behalf to see if they were interested in July (only 2-3 banks were showing interest in the USA).[42] To make the deal more attractive, Wille handled the operation personally rather than through shareholders, the FDIC promised support through a subordinated note against any losses arising from ignorance about the quality of the bank's assets (in case the situation was worse than anticipated) and agreed that the loan to the bank (about $1.3 billion) would continue.

After a competitive bidding process with four offers, the FDIC as official receiver sold off FNB's assets and liabilities to the European-American Bank and Trust Company (owned by six European banks) for $125m.[43] The liabilities and assets were valued at $1.369 billion, including the right of first refusal on FNB's 104 offices. In the meantime, overseas depositors and foreign funds depositors (whose assets were not insured) withdrew about $680 million in deposits from foreign branches, drawing on the liquidity provided by the Fed and the NY Clearing House banks. On 9 October, the 104 offices reopened and US depositors found business resuming as normal. As in the case of the US National Bank, the FNB was taken down by governance failures; Michele Sindona as the bank's controlling shareholder was subsequently charged and convicted of fraud. One of his other banks, the Banca Privata Finanziarian Banka Unione was bailed out by the Bank of Italy and then taken over by Banca di Roma in July 1974.

Like the Herstatt, the FNB collapse exposed the inadequacies of national prudential supervision and the perils of delaying acting on information about bank weaknesses. Additionally, this case highlighted the dangers of aggressive profit targets for foreign exchange dealing departments encouraged by the arbitrage gains in an increasingly volatile foreign exchange market. Figure 2 shows the sharp appreciation in the value of the USD in June 1974 and again at the start of August, which exposed foreign exchange traders.



Lloyds Bank International

The Lloyds Lugano debacle is illustrative of the challenges to supervision within banks and also reveals the tension between the attitude in the Bank of England and the Treasury to the changed international banking environment. Although small in size, the debacle prompted major changes in the Bank of England's supervisory practices as well as leading to the development of the new Banking Act of 1979. Rather surprisingly in hindsight, the scandal revealed that the Bank had no mechanisms to supervise overseas branches of UK banks despite an assumption that home offices were responsible for these branches (and they therefore posed a risk to the UK banking system). The Lugano scandal thus prompted changes to Britain's national supervisory practice.

The Deputy Governor of the Bank of England Jasper Hollom was first advised by Lloyds' London office that substantial losses had been identified at the Lugano branch over the weekend of 10-11 August 1974. The Lugano branch was small, with fewer than 20 employees and had been open only since 1970. Visa difficulties meant that the staff were Swiss nationals rather than transferred from head office and *The Banker* suggested that other banks had already hired the best talent by the time Lloyds entered the market.[44] Douglas Wass, Permanent Secretary to the Treasury was advised the following Monday, by which time the total losses had been identified as about £30m or $70m (equivalent to £260 million in 2011 using RPI or £500m as share of GDP).[45] In respect of Lloyds' overall balance sheet, this was equivalent to about 40% of the group’s pre-tax profits in the first half of 1974 so it was unlikely to bring down the bank, but there were important reputational, supervisory and foreign exchange issues.[46] Symptomatic of other subsequent cases, a dealer that had accumulated considerable losses was (for a time) able to hide these losses while trying unsuccessfully to ‘trade their way’ back to profit; an experience repeated in the Barings collapse of 1995 (losses of £827 million – which exceeded the firm’s total assets of c.$550m), Societe Generale (losses of $7bn/£4bn/Euro4.9bn in 2008) and the UBS rogue trading losses in September 2011 (losses of $2.3 billion).

The losses arose from a single, relatively young dealer, Marc Colombo (a 28 year old Swiss national – same age as Nick Leeson the author of Barings disaster and two years younger than Jerome Kerviel the rogue trader at Societe Generale) trading on the bank’s account accumulating unmet liabilities in dollars against foreign exchange purchases. Colombo had come to the bank in March 1973 and began accumulating dollar (and later DM) losses in January 1974 that at their peak amounted to about $550m according to prosecutors.[47] The investigation by Lloyds revealed that there were safeguards in place at the Lugano branch similar to the industry standard including head office limits on forward positions, and requiring branch managers daily to review vouchers and telex to and from the branch. Preparation of vouchers or telex was not undertaken by dealers themselves but by junior book-keepers. Lloyds determined these safeguards were circumvented by collusion between Colombo and the Branch Manager (Egidio Mombelli). The certificates relating to the forward exchange positions were passed through separate book-keepers, but when junior staff queried them they were assured by the manager that they were in order. The Lugano branch had been inspected by head office in March 1973 when Colombo was hired and was due for another inspection at the end of August 1974 just after the scandal broke.[48]

At first, Jaspar Hollom, Deputy Governor at the Bank of England and Lloyds officers rather naively believed that the losses ‘might be hushed up’. The Treasury Secretary Douglas Wass disagreed, but disclosure was delayed and journalists were kept at bay after appeals from the Swiss National Bank for continued secrecy.[49] The Treasury was very frustrated by the Bank of England’s complacent attitude. Hollom at the Bank casually remarked that there was probably no way to have caught a rogue dealer's speculation in time, although he admitted that the Branch Manager might have some responsibility. His initial reaction was that there was no cause to change any policies or practices. Financial Secretary Derek Mitchell's view on the other hand was that 'no organization with any pretentions to efficiency could accept a situation in which a loss of this magnitude was possible. Lloyds would have to do something if only to arrange that in future dealers worked in pairs'.[50] Mitchell suggested that Lloyds should make an announcement on the forthcoming long weekend to forestall the news dribbling out into the market but this was not taken forward. Mitchell concluded that 'we can have no confidence that this matter will be handled effectively by Lloyds but I hesitate to suggest that we should involve ourselves more directly lest any of the mud that may fly around sticks in the wrong place.' For the Financial Secretary, avoiding any semblance of responsibility prevailed over forcing Lloyds to take effective action.

Others were more forthright about the reputational aspects if it was discovered that the Bank or the Treasury had colluded with Lloyds in withholding important market information. On 29 August (two weeks after the Bank of England was aware of the losses) the Chancellor of the Exchequer asked the Bank of England to approach Lloyds again with a view to public disclosure.[51] Lloyds claimed that the Swiss authorities were asking them to wait until they were assured that all losses had been identified and Lloyds hoped to delay an announcement until their normal third quarter report in October if it was not leaked to the press.[52] In the event, the press in Switzerland were threatening to publish the story and so the losses (and the fact that they had already been recovered) were announced on 2 September 1974 almost a month after the debacle had been discovered. The key aspect for Lloyds was to avoid an announcement until they could say that the losses had been made good. Colombo was arrested by the Swiss authorities a week later charged with falsification and suppression of documents and both he and Mombelli were convicted at Lugano Criminal Court at the end of October 1975.

At the Bank of England, the Lugano debacle raised a debate over whether there should be British controls on or even supervision of branches of UK banks overseas.[53] This could extend to foreign exchange limits, monitoring Eurocurrency dealing or other assets/liabilities, capital or liquidity ratios. John L. Sangster noted that 'prima facie the losses sustained by the LBI branch in Lugano suggest that we first turn to the foreign exchange area and impose some sort of reporting and possibly limits akin to those that we impose on banks in the UK'. But he pointed out that UK controls on FX dealing were not prudential, they were designed to protect the foreign exchange reserves from demands from interest arbitrage or long positions, so there were also only monitored against sterling (not among other currencies). The limits were thus a tool of exchange control related to the balance of payments, not to contain risk of individual institutions. Formal limits were imposed by the Bank of England to be observed daily and spot checks could be made at any time, but reports of overall positions were usually examined weekly with more detailed reports monthly. The basic limits were £50,000 combined spot and forward open positions and £100,000 spot foreign assets could be held against forward sales of foreign currency, although some banks were given larger limits (mainly multinationals and clearers). The total UK limits over about 240 authorised dealers in early September 1974 was £55m Open, £81m Spot held against forward sales, making a total of £209m. Additionally the Bank reported that 'we very rarely find that a bank has a position exceeding £10 million in any one currency, and make enquiries when this occurs'.[54]

Sangster posited 'do we then just shrug our shoulders at the losses incurred by LBI Lugano? There is sometimes a management advantage in not overloading administrative procedures by over-reacting to a single instance of loss. But there is a problem in the LBI Lugano area which we have to probe, perhaps to satisfy our own misgivings and certainly to satisfy the paternalistic instincts of HMT'. This problem was whether the geographical as well as cultural distance from normal UK practice 'mean that foreign branches have much more autonomy and scope for error and adventure?' and whether they are therefore adequately supervised by their parent home office. This was tacit acceptance that the Bank's prudential supervision of banks in London was based largely on local culture, moral-suasion and peer pressure that might not be effective in other banking centres. Here Sangster saw an opportunity to follow up the Lugano 'case'.[55]

Pressure from the Treasury and a reluctant recognition that there was a gap in supervision eventually prompted the Bank of England to draft a letter to warn banks to exercise effective control over their branches both within and outwith the UK, particularly since the foreign exchange positions of branches and subsidiaries overseas were not included in the regular returns made to the Bank of England.[56] Even this step was controversial within the Bank, with some finding it 'otiose and naive and that its only justification would be the cosmetic effect of suggesting to Whitehall that we were not letting Lugano pass into oblivion without taking action'[57] while Fenton argued that 'this is an area in which we have a responsibility' particularly if the banks were likely to call on the reserves 'to rectify misjudgements or misdemeanours'.[58] Hallett advocated a 'low key' and 'more chatty form' to be sent to general managers from Blunden or the Chief Cashier rather than the Governor, but he also wanted some side mention of the 'need to watch the relationship of young dealers with brokers…and the danger inherent in board policies which have in recent years…laid down profit targets or created profit expectations for the dealing operations of their banks'.[59] After nearly a month it was finally agreed that formal advice would not merely be 'cosmetic' and that the Bank should monitor the dealing limits given to branches and subsidiaries to 'ensure that senior management of banks keep such authorities under strict review' as well as allowing the Bank to identify where 'unduly lax' practices were being applied.[60] The letter was to go not only to all authorised banks registered in the UK (113), but also to authorised branches of foreign banks in London (141). The Chancellor of the Exchequer was also shown the letter in advance as evidence that the Bank was taking some action in response to Lugano, so it served the 'cosmetic' purpose. The Governor, Gordon Richardson, worried that the press might latch on to the letter and urged that it be 'played down as much as possible in the press…certainly emphasise that this is not inspired by fear of another "Lugano"'.[61] He thus worried about perverse effects on confidence from a general reminder of good practice.

As finally composed the letter called on banks to undertake a review of internal regulations and FX limits and set out an indicative check-list for that review. The major change in practice was that the Bank asked to be informed of the limits and authorisations that head offices allowed for each of their overseas branches *and subsidiaries* and to report when these changed and how frequently they received reports from these offices. This marked an important departure in the Bank's oversight of the foreign activities of London registered banks.[62]

Table 2: Letter of Guidance for Banks to Control their Overseas Branches

First Draft 25 October 1974 (Rodney D. Galpin)	**Final Draft 20 December 1974**
FX dealing rules should be clear in internal regulations	
HO to set limits for branches	BoE to be told the FX limits applied to overseas branches *and subsidiaries*
Dealers should not handle confirmation of deals or related matters	Dealers should never write their own outgoing confirmations or receive incoming confirmations
Manager/those not directly involved in dealing should scrutinize confirmations of FX deals	
Spot checks on branches in addition to regular audit visits,	Snap checks of dealing between regular internal audits
Reciprocal checks with correspondents on forward contracts recorded in their books	Central management randomly seek second confirmations of outstanding forward contracts from correspondent banks
	Check with correspondent's main office if it notices a branch of that bank suddenly increasing operations in forward market
	Dealers exposed by management imposing ambitious profit targets
	Monitor relations between dealers and brokers
	Forward deals confirmed immediately, not delayed until instructions are passed just prior to maturity.

To enhance self-regulation, the Bank recommended that banks exploit correspondent relationships to monitor their branches' activities – a suggestion that arose from Belgian and other continental jurisdictions. At the same time as the letter was being sent to banks, Lloyds Bank made efforts to establish a permanent system of confirmations for FX deals to replace the arrangements for sending confirmations to originating branches in order to tighten up internal supervision.[63] Airey, at the Treasury, found this 'the most promising of the various measures proposed so far' since the list of checks in the Bank's letter were already operated in prominent banks such as Lloyds.[64]

A final aspect of the Lugano affair was how the Bank of England responded to the call for foreign exchange by Lloyds to meet the obligations of $70m. On 19 August Lloyds was allowed by buy $25m directly from the foreign exchange reserves rather than through the market. The crisis thus led to a direct drain on the foreign exchange reserves, although this only amounted to 0.5% of convertible currencies held in the reserves. The Bank allowed this because of 'the size of the initial amount required, the desire to protect the bank's name, the fact that the funds were wanted for the next day rather than for ordinary value, and the general state of the market'.[65] Ordinarily banks were required to borrow funds in the Eurodollar market to transfer to branches overseas or to buy the currency in the foreign exchange market. The rest of the transfer to cover losses (approximately $45m) was accumulated and transferred by Lloyds through the foreign exchange market over the next two weeks. Responsibility to support the foreign branches of UK banks thus posed a potential claim on the foreign exchange reserves. There was also concern about the assets of the London branch of FNB, whose assets were claimed by the Fed as part of the liquidation of the FNB. This raised an exchange control issue (whether the assets could be transferred) and if not then whether this might 'imply a wider acceptance of responsibility on our part for the conduct of London branches of foreign banks than we would wish'.[66]

The prospect of helping banks out with their foreign currency liabilities was a difficult one. Hallett was rather pessimistic about the prospects for using the foreign exchange reserves of the EEA for this purpose, despite the fact it was used for Lloyds.[67] There were legal objections since the EEA was to be used only to avoid pressure on sterling and to preserve the reserves. Practically, the offer of such support would have to be very quick to forestall contagion, but the ultimate liability was often not known until much later – as was the case with the FDIC support for FNB. He cited the case of Israel-British Bank, where 'if the Israel British had been a true London bank we might, so soon after Herstatt, have committed the reserves at once. It is only now emerging that their assets are largely of dubious value; and the effect on London and sterling has proved in the event to be negligible'. Rather than ex post support Hallett emphasized that 'there are a number of preventive measures [in the Eurocurrency market] which it is important to keep in play all the time, such as inter alia avoiding the undue pressures for which the Japanese have recently been responsible, keeping a close watch on the temperature of the market and ensuring that the banks appreciate their responsibilities and do not add to the problems by unwise behaviour' and not letting HMG borrowing strain the market's liquidity. Market intelligence was also gleened from particular participants (Stonor at Rothschild International and Raw at Italian International Bank both had telephone conversations with McMahon to report on how easy their access to the Eurocurrency markets was in August 1974, for example).[68]

It wasn't just branches where governance was problematic. International Westminster, a subsidiary of Natwest, also found itself with unauthorised credit risk in 1973 as a result of 'a new branch which very quickly expanded turnover to an almost incredible extent'.[69] In the the first half of 1973 the IW branch in Frankfurt entered into deals totalling $4.5 billion with the Banca Privata Italiana. Although these were entirely covered in the market so there was no exchange risk, they did constitute a substantial credit risk. The deals were gradually run off at maturity in the second half of the year and reporting systems between the subsidiary and Natwest were strengthened. Another example was the suspension of the Swiss International Credit Bank in October 1974. Its London representative office was clearly deemed to be the responsibility of the home Swiss Federal Banking Commission. The London office was not an authorised FX dealer but did have limited FX facilities; at the time of closure about £3m of sterling deposits and $20m in non-sterling deposits was at risk.[70] The gyrations in the foreign exchange market thus exposed a range of institutional structures with relatively clear trails of responsibility, but this clarity was challenged by the collapse of the Israel British Bank.

The Israel-British Bank

The Herstatt crisis was the proximate cause of the failure of a small Israeli bank, which had far reaching policy implications, although it was not itself systemically important. The Israel-British Bank Ltd. had a subsidiary IBB (London) Ltd., which collected mainly foreign currency deposits in London and remitted them to the head office in Tel Aviv. Since it was an authorised bank in London it had no limits to its FX dealing and was not closely supervised. After the freezing of deposits at Herstatt, three of IBB (London)'s customer banks were unable to renew their deposits amounting to about $18 million. IBB (London) was unable to redeem the deposits with its own cash, leading to a liquidity problem.[71] Additionally, there were undisclosed losses on the FX market, originally believed to amount to about $4m and DM6m. Further deposits were withdrawn and by mid-July, making good the deposits that had been lost was believed to require about $77 million (£50m).[72] After further investigation, it emerged that both offices of IBB had been involved in fraud discovered by the Bank of Israel noticing that the currency book of the Tel Aviv office was mismatched. The Head Office was suspended on 9 July and the London office closed on 11 July. The bank had originally been owned by British national Walter Nathan Williams and when he died in 1971, his sons-in-law (Harry Landy and Joshua Bension) took over control of both banks' boards. They continued to report transfers of FX to Tel Aviv on the IBB (London) books, but in fact credited the funds to four companies registered in Liechtenstein. Repayments of principal and interest from Liechtenstein were reported as coming from head office but in July 1974 they ceased to be remitted, leaving the banks insolvent.

The Bank of England's position was that the parent bank in Israel was responsible to make good the foreign currency losses and that the Bank would not sell foreign exchange from the reserves for this purpose. This firm approach found agreement in the Treasury.[73] The Bank of Israel quickly accepted responsibility for the Israel-British Bank in Tel Aviv (guaranteeing deposits and putting the bank into the management of Bank Leumi), but the Israeli Cabinet refused to allow them to take over the London subsidiary without further investigation of its business.[74] In the meantime, the Chairman, Harry Landy (a British national) was persuaded by the Bank to take on Natwest and Rea Brothers (merchant bankers) as advisers.[75]

The Bank of England was adamant that they would not bear responsibility for the deposits of the London subsidiary and that the foreign reserves should not be used to support a foreign controlled bank. The Treasury began to question whether it might be worth the $77 million to avoid a loss of confidence in the City if that was threatened. However, the IBB (London) did not appear to have any contagious effects since it was a small bank and had taken deposits from a large number of parties so that no other bank was particularly exposed.[76] Given the dangers of a precedent for British responsibility for subsidiaries, the Treasury requested formally that it expected to be consulted about any further action should the Israeli authorities not be persuaded to take responsibility.[77] The Department of Trade (responsible for authorising banks to deal in FX) was concerned that this meant that authorised dealers in London would not be 'assured of rescue if they are foreign controlled'. They worried that this would not have been understood ex ante to many depositors such as insurance companies and building societies.[78] 'Authorisation' seemed to imply some supervision and responsibility that was not backed up the Bank of England's actual practice.

On the morning of Friday 2 August 1974, Moshe Sanbar, Governor of the Bank of Israel told Richardson that he could not recommend to his government that it assume any responsibility for IBB (London) since 'there is no doubt in my mind that this institution has engaged in unsound and irresponsible practices'.[79] This decision implicitly put the blame on the Bank of England for failing to exercise prudential supervision, a claim made explicitly in the Treasury. RH Seebohm remarked that 'the Bank seem to have exercised no thorough supervision of IBB and much explanation will be called for'.[80] That day IBB (London) applied to go into voluntary liquidation and six days later, after a report by Binder Hamlyn on the London office, Bension was arrested in Tel Aviv. IBB (London) at this point had about £3-5 million of 'good' assets, a range of assets related to Landy companies and personal loans to Landy of about £1 million. Currency deposits amounted to the equivalent of £40 million including liabilities to 'reputable' banks and the Crown Agents, although no single deposit exceeded £2 million.[81] The Williams family also controlled two insurance companies who had deposits (Sentinal life assurance and National Insurance and Guarantee property insurance) as well as a property company London City and Westcliff. Apal Travel (aka 'See Spain') held a licence from the CAA against a £140,000 bond by IBB which was also at risk, affecting some 10,000 holiday makers (it subsequently ceased trading). The systemic banking threat, however, was considered minimal given the broad spread of depositors so the Bank of England remained opposed to any bail out of local depositors.

At this time relations with the Israeli government were complicated by British refusal to relax exchange control on British residents buying Israeli bonds, but it was decided that raising the IBB (London) debacle in this conversation would likely further sour relations.[82] In September the Bank of England anticipated that a Canadian company would take over the Williams empire and meet most of the liabilities of IBB (London), but this plan was later abandoned.[83] By early October the Bank of England had persuaded the Bank of Israel to take some responsibility for London depositors, mainly by agreeing to contribute support themselves through a transfer to the Bank of Israel. Private depositors were to be paid in full, banks at a discount and Williams family creditors left unpaid.[84] The negotiations were prolonged until September 1975 when the Bank of Israel agreed to relinquish its DM30m deposit (c.£5.5m) with IBB (London) so long as the bank of England agreed to contribute £3m to meet claims against IBB (London), although the Bank of Israel continued to claim that the subsidiary was outside its prudential and regulatory jurisdiction.[85] The deal allowed all personal depositors under £25,000 in IBB (London) to be repaid in full, remaining creditors about 38% and Williams family interests nil. The Bank of England's position was that its concession was only due to the fact that the failure occurred before it was clear to the market that subsidiaries and branches should look to their home authorities for support, making clear that there was no precedent being set for the Bank bailing out foreign-owned banks in the future.[86] The IBB debacle led directly to Governor Richardson pressing for a collective ruling at the BIS on responsibilities for different forms of international banking institution even before the foundation of the Basel Committee.[87] This subsequently became a primary focus of the Committee's deliberations, culminating in the Concordat of 1975 after it had rejected the 'early warning system' prompted by the Herstatt collapse.

Conclusion

The failure of a range of banks across Europe and the USA as well as the need to activate lender of last resort facilities to a wider range of institutions exposed a variety of institutional structures operating across countries, but also prompted some similarities in response. Importantly, in each case the domestic banks were 'bailed in' to the solution. In the cases of Germany, the UK and the USA lender of last resort responsibilities were shared between central banks and commercial banks either through ad hoc institutions such as the Lifeboat or more permanent arrangements such as the LiKo-Bank. For the USA the FDIC took on these responsibilities as a receiver for failed US banks and broker for selling them off, funded by subscriptions from the banking system, but ad hoc arrangements also 'bailed in' the banking sector: in the case of the Franklin National Bank, the New York Clearing House members contributed a substantial line of credit. The legal and practical problem of determining who was responsible for international banking liabilities was a more contentious issue and was dealt with in an ad hoc way that at times damaged market confidence. More starkly, the rash of bank failures exposed a dangerous lacuna in international banking supervision of branches and subsidiaries of foreign banks, which seemed to fall between home and host authorities.

The collapse of Herstatt affected international markets briefly in the Summer of 1974, but this was mainly overcome by the end of September so the effects were fleeting. The bank had little systemic impact beyond tightening credit and access to the foreign exchange market for smaller international banks and this was overcome by promises of support from the Bank of England and restraining the 'bidding up' of interest rates by the banks themselves. The most important element of the collapse was its timing, which revealed the vulnerability of London's markets to actions taken in other jurisdictions. This reinforced the impetus for greater information exchange among supervisors. In this case, the Bundesbank claimed that the timing of the closure was out of their hands, so it is not clear that central bank contacts would address the issue, but this was nevertheless the format for developing informal flows of information at the BCBS. The Herstatt and the FNB also revealed the inconsistent nature of how central bankers dealt with market information – in both cases the fragility of the banks was clearly known well in advance but little was done over a period of some months until the banks were insolvent. Further informal exchange of information was unlikely to resolve the problem, which had more to do with how domestic prudential regulations were enforced.

The impetus for British involvement in the Basel Committee was to fill the apparent gaps in supervisory oversight for international banks (both branches and subsidiaries) and this occupied the early meetings of the Basel Committee after the early warning system was abandoned. This issue did not arise from the Herstatt or FNB collapses but from the less famous IBB (London) and Lloyds Bank International affairs which brought out the jurisdictional gaps clearly. In the case of losses in a branch of a London bank, the Lugano affair showed that that responsibility was uncontroversially at the door of the parent institution, if necessary supported by the foreign exchange reserves of the home country. The involvement of the Swiss authorities as they tried to ascertain the extent of the losses merely delayed the announcement and there was no consideration that they might be involved in any bail-out if it were necessary. Although the losses were not great and there was no systemic effect, the extent of rogue trading at the Lugano office of one of the major London clearing banks prompted an overhaul of domestic banking supervision as it revealed the gap in the British system which ignored foreign branches of London banks. As the guidance to banks was developed, it moved to encompass not only branches but also subsidiaries of UK banks.

For the Bank of England, the prolonged conflict with the Bank of Israel over responsibility for a London subsidiary of a foreign bank, and their eventual capitulation to partially bail out creditors, provided a stark lesson of the need to clarify jurisdiction for international banks. They had assumed that a tacit principle of responsibility of home offices for branches would extend to subsidiaries but this was clearly not the case. They had to acknowledge that their own understanding that the Bank would not support London subsidiaries of foreign banks was not necessarily understood ex ante by the banking community and in the end the Bank of England had to contribute to the bail out (providing 'new' money, where the Bank of Israel merely wrote off its deposit at the IBB (London)).

While the Herstatt and FNB failures captured the headlines and have been entrenched as the impetus of the Basel Committee, this paper has shown that two smaller episodes had greater impact on the Committee's approach and agenda. Blunden as chair of the Basel Committee quickly abandoned the plans for an early warning system prompted by the Herstatt and FNB collapses, relegating it to exchange of 'gossip' at the monthly meetings of the Committee. Instead, the main efforts of the Committee were tightening up governance of the FX market and establishing the concordat on supervisory jurisdictions: prompted by the Lloyds and IBB respectively.

[1] Research was supported by ESRC Grant Ref: RES-062-23-2423 and by the research assistance of Dr. Emmanuel Mourlon-Druol.

[2] Staff involved in prudential supervision may have inferior understanding to those employed in banks themselves, partly because the salaries in supervisory institutions are lower than in banks. E. Ribakova, Liberalization, prudential supervision and capital requirements: the policy trade-offs, IMF Working Paper, WP/05/136, July 2005.

[3] For example, self-regulation of stock markets, foreign exchange brokers.

[4] *Core Principles for Effective Banking Supervision* (first edition 1997, updated October 2006) and *1999 Core Principles Methodology*

[5] In the UK in particular, the Department of Trade was responsible for registering some financial institutions without reference to the Bank of England so the distribution supervisory responsibility was opaque.

[6] For links from Herstatt to the Basel Committee see, J.W Markham, *A financial history of the US*, Vol. 2, M.E. Sharpe, 2002, p. 20. D. Wood *Governing global banking: the Basel Committee and the politics of financial globalisation*, Ashgate, 2005, p. 48-50. *The Economist*, 'One Basel leads to another', 18 May 2006, 'The Basel rules have their origin in the failure of Germany's Herstatt Bank in 1974. Herstatt defaulted on contracts with banks overseas, highlighting the need for more international co-operation among banking regulators.' Goodhart also emphasises Herstatt over other bank collapses and doesn't discuss the Lloyds Lugano debacle. C. Goodhart, *The Basel Committee on banking supervision: a history of the early years*, Cambridge University Press, 2010.

[7] M. Reid, *The secondary banking crisis 1973-75; its causes and course*, Macmillan, 1982. For a recent archive-based account of the secondary banking crisis in London see F. Capie, *The Bank of England 1950s to 1979*, Cambridge, 2010, pp. 524-586.

[8] a fundamental weakness echoed in causes of the failure of Northern Rock in 2007 where low-interest and high risk mortgages had been funded through wholesale borrowing

[9] NL Wicks, HMT to AR Powell, FCO passing on intelligence from a Private Investigator Stuart Allen 29 March 1972. Other banks who had opened in Tortola in the previous few months included Merchants Banking and Trust co ltd, Pan American bank ltd, Can-Am bankig co ltd, Archway bank ltd, Island and Overseas Bank Ltd
First foundation bank ltd, Lincoln bank ltd, Securities Investment Bank Ltd, Worthing Bank Ltd, Global Trust co Ltd, Euro-American Bank Ltd, Euro-Continental Bank Ltd, Madison Bank ltd, Bankers Deposit and Finance Corp, Edinburgh Insurance co, Investors Fidelity and General Insurance co. UK National Archives [hereafter TNA] T236/1529.

[10] An early casualty was WestLB was created in 1969 from the merger of Landesbank für Westfalen Girozentrale, Münster, and the Rheinsche Girozentrale und Provinzialbank, Düsseldorf. It was one of the founding partners in the innovative consortium bank, Orion Bank Ltd. (with Chase Manhattan and 2 others) but its rapid expansion resulted in failures of internal governance that exposed it to losses from unauthorised and imprudent lending in 1973, leading to losses of $150 million. It set up its London branch in 1973.

[11] Markham (2002), p. 20.

[12] A. Busch, *Banking Regulation and Globalization*, Oxford University Press, 2009, p. 100.

[13] Bank of England Archives [hereafter BoE] 394A/2 JLS Memo of Gold and Foreign Exchange Meeting, Basle, admitted by Tungeler of Bundesbank,11July 1974.

[14] BoE 394A/2 Memo 26 June 1974. The London representative was Ditmar Gebhard at 52 Cornhill.

[15] BoE 394A/2 Memo for McMahon and Governor's Private Secretary, 4 July 1974. Account of discussion with Stauch of Bundesaufsichtsamt fur das kreditwesen.

[16] The Basel Committee's own account of the Herstatt collapse is inaccurate with regard to the timing of the initial Federal Banking Supervisory Office's investigation, stating it only became involved in March 1974. BIS, Basel Committee on Banking Supervision, Working Paper No. 13, 'Bank Failures in Mature Economies', April 2004.

[17] BoE 394A/2 Derek Mitchell to JCH Hallett, 24 June 1974.
[18] BoE 394A/2 JLS memo of gold and Foreign Exchange Meeting, Basle, 11 July 1974.
[19]BoE 394A/2 BoE 394A/2 Memo for McMahon and Governor's Private Secretary, 4 July 1974. Account of discussion with Stauch of Bundesaufsichtsamt fur das kreditwesen Tungeler at the Bundesbank first heard of the heavy losses arising from forward operations in the foreign exchange market on the weekend of 22/23 June and tried unsuccessfully to assemble a consortium of German banks to take the Herstatt over.[19]
[20] CHIPS was set up in April 1970 by 9 leading US banks and came to dominate settlements in US dollars.
[21] Losses were estimated at DM400m. Kurt H. Nadelmann, Rehabilitating international bankruptcy law: lessons taught by Herstatt and Company', *New York University Law Review*, Vol. 52(1), April 1977. ppl 1-35.
[22] A. Busch, *Banking Regulation and Globalization*, 2005, p. 100.
[23] BoE 349A/2 Governor's Brief for Chancellor of the Exchequer, 17 July 1974.
[24] BoE 349A/2 Governor's Brief for Chancellor of the Exchequer, 17 July 1974.
[25] BoE 394A/2 memo from Dealing Room, 18 July 1974.
[26] BoE 304A/2 Memo JLS 18 July 1974 for Hallett and McMahon.
[27] BoE 394A/2 Note for the Record George Blunden, 25 July 1974.
[28] BoE 394A/2 Memo of BIS Gold and Foreign Exchange Committee meeting at BIS, 10 July 1974.
[29] BoE 394A/2 Minutes of meeting of the London Foreign Exchange Sub-committee, 12 July 1974.
[30] BoE 394A/2 Memo RCC Hallett, 1 July 1974
[31] Joseph D. Decker, 'International Insolvency; the case of Herstatt', *American Bar Association Journal*, 1976, pp. 1290-95.
[32] BoE 394A/2 JLS memo of Gold and Foreign Exchange Meeting Basle, 11 July 1974.
[33] Memo, March 1978, BoE 1A179/17. LKB is mentioned in G. Franke, 'The Bundesbank's role in banking supervision', in Deutsche Bundesbank ed., *Fifty years of the deutschemark; central bank and the currency in Germany since 1948*, Oxford, 1999.
[34] Informal record of 1st meeting CBRSP, 6-7 February 1975. BISA 1.3a(3) Vol. 18.
[35] Preliminary report to the governors by the CBRSP on international early-warning systems, BS/75/30. Informal record of the third meeting of the CBRSP, 19-20 June 1975. BISA 1.3a(3), Vol. 18.
[36] F. Wille, Chairman of FDIC, 'the FDIC and Franklin National Bank: a report to the congress and all FDIC-insured banks', 23 November 1974. BISA. See also, J. Spero, *The Failure of the Franklin National Bank; challenge to the international banking system*, Beard Books, Washington D.C, 1999.
[37] Spero (1999), p. 80-81.
[38] J.W. Markham, *A financial history of the United States; from the age of derivatives into the new millenium, Vol. 3*, M.E. Sharp, 2002, p. 19.
[39] Spero (1999), p. 90.
[40] The development of the Eurocurrency market and international bank lending since the oil price increase and its macro-economic policy implications, 20 March 1978. BISA 1.3a(3)b, Vol. 1.
[41] BoE 394A/2. Note to Governors, 17 June 1974, Note for the record 6 June 1974.
[42] BoE 394A/2 C McMahon memo 4 July 1974
[43] The trust business of FNB was sold separately to the Bradford Trust Company.
[44] *The Banker*, Volume 125; Volume 125, pp. 1544.
[45] Memo D Wass for Financial Secretary Lawrence Airey, 12 August 1974. TNA T233/2942. The total losses were later reported to be £32m or $78m.
[46] L Airey to Derek Mitchell and PP Sec to Chancellor of Exchequer, 29 August 1974. TNA T233/2942.
[47] 09 Sep 74 HANNS NEUERBOURG Associated Press. http://w071.z064002061.sjc-ca.dsl.cnc.net/1974/09/09/%5D.TXT%5BAP,SYS%5D

[48] Memo Derek Mitchell of a lunch with Hollom, for Postmaster General, 23 August 1974. J.S. Fforde to L Airey, 4 October 1974. TNA T233/2942.
[49] Memo by Derek Mitchell, 22 August 1974. T233/2942.
[50] Memo Derek Mitchell of a lunch with Hollom, for Postmaster General, 23 August 1974
[51] SA Robson, Chancellor of Exchequer's office to Private Secretary to Financial Secretary, 29 August 1974.
[52] Derek Mitchell, 28 August 1974. TNA T233/2942.
[53] BoE 349A/2 Memo by JLS for McMahon, 19 September 1974.
[54] BoE 394A/2 Hallett memo for Governor, 5 September 1974.
[55] Meanwhile, on 15 October 1974 the Banque de Bruxelles, Belgium's second largest clearing bank announced losses through irregularities in their foreign exchange office amounting to about Bfr1-2.5m similar to LBI through a few employees' unauthorised trading on their own account.
[56] BoE 349A/2 Draft letter from Governor to Chairmen of British banks, 25 October 1974.
[57] BoE 349A/2 Note from Blunden to Fforde and McMahon (not expressing his own views) 29 October 1974. The Chief Cashier, John Page was opposed to the letter's tone and wished it to be 'exhortatory'. Note from Blunden to McMahon and Fforde, 6 November 1974.
[58] BoE349A/2 Note by Fenton to Blunden, 30 October 1974.
[59] BoE 349A/2 Hallett to Blunden, 4 November 1974.
[60] BoE 349A/2 Blunden to Fforde 18 November 1974 enclosing agreed letter.
[61] BoE 349A/2 Blunden Note for the Record, 16 December 1974.
[62] BoE 349A/2 Letter from Governor to banks, 20 December 1974.
[63] TNA 233/2958 John Fforde to Laurence Airey (HMT) enclosing letter to banks, 19 December 1974.
[64] TNA 233/2958 L. Airey to Principal Private Secretary 23 December 1974
[65] J Hollom to Derek Mitchell, 27 August 1974. TNA T233/2942.
[66] BoE 394A/2 Memo by EBB for Blunden, 17 September 1974.
[67] BoE 394A/2 Hallett memo for McMahon 'Rescue Action in the Euro-currency Markets', 25 July 1974.
[68] BoE 394A/2 McMahon report to Governor, 2 August 1974
[69] BoE 394A/2 Note by JL Sangster, 8 November 1974.
[70] TNA 233/2958 Note for the Record, R.H. Seebohm, 10 October 1974.
[71] This detail from a Swiss newspaper report from Schweizerische Finanzzeitung in TNA 233/2958, 31 July 1974, sent by Bank of England to Treasury.
[72] TNA 233/2958 Note by T.U. Burgner, 12 July 1974.
[73] TNA T233/2958 T.U. Burgner memo for Littler, 9 July 1974.
[74] TNA T233/2958 C.W. France Note of Conversation of Governor Richardson with Chancellor of Exchequer, 11 July 1974.
[75] TNA 233/2958 Note by T.U. Burgner, 12 July 1974.
[76] TNA 233/2958 Note by T.U. Burgner, 12 July 1974.
[77] TNA 233/2958 T.U. Burgner to EB Bennett (BoE), 15 July 1974.
[78] TAN 233/2958 RH Seebohm to Unwin, 17 July 1974.
[79] TNA T233/2958 Telegram from Moshe Sanbar (Bank of Israel) 2 August 1974 10:46 to Gordon Richardson.
[80] TNA 233/2958 R.H. Seebohm Memo, 9 August 1974.
[81] Banks with deposits included United California Bank, North Carolina Natinal Bank, Internatioanl Westminster Bank, Girard Trust of Philadelphia and Crown Agents. There were over 200 creditors. Financial Times 4 January 1975.
[82] TNA 233/2958 Note by CHW Hodges, 11 September 1974
[83] TNA 233/2958 Memo by RH Seebohm for Postmaster General, 16 September 1974.
[84] TNA 233/2958 Note for the Record, R.H. Seebohm, 10 October 1974.
[85] Guardian, 11 September 1975.
[86] TNA 233/2958 RH Seebohm to Bridgeman, 11 September 1975.

[87] C. Goodhart, *The Basel Committee on Banking Supervision; a history of the early years*, 2010, p. 39. Discussion behind the press communique of 10 September 1974. Goodhart describes Richardson as a ‘driving force’ behind the founding of the BCBS (p. 56)