



**Reforming Global Banking Rules:
Back to the Future?**

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ABSTRACT

One of the most significant casualties of the recent financial crisis has been the Basel II Accord, a set of proposals to regulate the international banking system drawn up by a committee of G10 banking supervisors between 1999 and 2004. Whether or not they view Basel II as a direct contributor to the crisis, policymakers agree that the fundamental tenets of the accord have been decisively discredited by recent events. In this paper, I ask why Basel II's creators fell so short of their aim of improving the safety of the international banking system – that is, why Basel II failed. Drawing on recent work on global regulatory capture, I present a theoretical framework which emphasizes the importance of timing and sequencing in determining the outcome of rule-making in international finance. This framework helps to explain not only why Basel II failed, but also why the latest set of proposals to regulate the international banking system – the so-called 'Basel III' Accord – is likely to meet a similar fate.

I. INTRODUCTION

The recent financial crisis, perhaps more than any other event in modern economic history, has highlighted the need for robust regulation and supervision of the international banking system. The crisis laid bare a flawed financial architecture, designed by a handful of wealthy nations and limited to a small fraction of cross-border activity, which did little to prevent the catastrophic buildup of systemic risk in the years preceding the crisis. One of the key elements of this failed architecture was the Basel II Accord, a set of regulatory proposals to govern the international banking system drawn up by the Basel Committee on Banking Supervision (BCBS), a group of G-10 banking supervisors. “After the current crisis,” the economist Joseph Stiglitz has declared, “it is clear that Basel II is dead.”¹ Nouriel Roubini, meanwhile, argues that, “All the pillars of Basel II have already failed even before being implemented”.² Some have even suggested that Basel II, although adopted only in the European Union in mid-2007, was itself one of the underlying causes of the crisis.³ The shortcomings of the accord are especially puzzling given that the fundamental aim of the Basel Committee, when it set out to reform banking rules in 1999, was to craft an accord that significantly *improved* the safety and soundness of the international banking system. In this paper, I ask why Basel II fell so short of its creators’ expectations – that is, why Basel II failed. In answering this question, I also hope to explain why the latest attempt to regulate the international banking system, the so-called ‘Basel III’ accord, is likely to meet a similar fate.

Basel II’s failure, I argue, lies in regulatory capture, “de facto control of the state and its

regulatory agencies by the ‘regulated’ interests, enabling these interests to transfer wealth to themselves at the expense of society”.⁴ Large international banks were able to systematically manipulate Basel II’s regulatory process to their advantage, allowing them to maximize rents while at the same time penalizing their smaller and emerging market competitors and, above all, taxpaying consumers. To understand why this happened, I present an analytical framework which sets out the broad conditions under which capture is expected to occur. My framework draws on what I call the ‘neo-proceduralist’ school of global regulation, developed in recent work by Walter Mattli and Ngaire Woods, which emphasizes two types of conditions. The first are so-called ‘supply-side’ conditions concerning the institutional context in which Basel II was drafted, and the second are ‘demand-side’ conditions concerning the extent of societal pressure for new regulation. I argue, however, that the neo-proceduralism can be strengthened as a theory of global regulatory processes by proper *temporal* contextualization. It is only by conceiving of capture as a process that unfolds over time that we can appreciate the exact mechanisms by which supply- and demand-side factors combined to give large international banks disproportionate influence over the Basel process. As it will later become clear, this theoretical innovation has implications that go beyond Basel II. It allows us to understand not only why the Basel Committee failed to achieve its objectives for Basel II, but why its latest attempt to reform international banking regulation – despite the tremendous political will behind it – is likely to enjoy no more success. The fate of the ‘Basel III’, my analysis warns, may very much be a case of history repeating itself.

There are few areas of regulation as closely linked to broader macroeconomic stability and

¹ Stiglitz 2008, 21.

² *Financial Times*, February 9 2009.

³ See Blundell-Wignall and Atkinson 2008.

⁴ Mattli and Woods 2009, 10.

efficiency as banking regulation. Banks occupy a pivotal position in the economy, both as the basis of an efficient payments system and the key agents of financial intermediation – transforming the savings of those with a surplus (lenders) into productive investment by those with a deficit (borrowers). In part to protect the deposit insurance fund and in part to minimize the often enormous negative externalities associated with bank failures, regulators tend to impose a variety of prudential standards on banks aimed at ensuring their safety throughout the economic cycle. Over the past 25 years, capital adequacy requirements have emerged as the dominant form of prudential regulation. The rationale for holding regulatory capital – mostly made up of shareholders' equity – against bank assets is to provide a buffer against unexpected losses, allowing the bank to continue to operate during periods of stress. Where requirements are not high enough, banks will not have sufficient capital to cover their losses; liabilities will quickly come to outweigh assets, rendering them insolvent.

Unfortunately for banks, capital requirements come at a cost. Since equity is significantly more expensive than debt as a source of financing, when banks are forced to maintain capital buffers exceeding their preferred level, they tend to these requirements as a form of 'regulatory taxation'.⁵ By lowering their capital levels, banks can in theory reduce funding costs, increase leverage and boost their return on equity. For banks with sizeable asset bases, a tiny percentage reduction in capital requirements can represent a windfall of billions of dollars. As I show later, the incentive to minimize capital has proved too strong to resist. By hijacking the Basel process, large international banks effectively rewrote the rules of international capital regulation to give themselves free rein to set their own capital requirements. The

result was an accord that allowed those institutions that posed the *greatest* threat to the stability of the financial system to hold the *least* capital – a recipe for economic disaster.⁶ Understanding why these initiatives have failed to achieve the proper goals of capital regulation, then, has important implications for future efforts to create rules governing the international banking system and, by consequence, the future health of the global economy. Such an investigation will yield substantive conclusions about the conditions needed to produce banking regulation that serves the interests of society as whole, rather than the interest of those being regulated.

The paper is organized as follows. Section II begins with a brief history of the Basel Committee and the transition from the first Basel accord to the second, before describing in greater detail the Committee's failure to achieve its stated aims for Basel II. In section III, I assess existing explanations of this failure, highlighting their analytical shortcomings. My main theoretical and empirical contribution is presented in section IV. While drawing on the 'neo-proceduralist' school of global regulation, I argue that only by injecting 'time' into its comparative-static framework can we fully understand the politics of international banking regulation. This is followed by a close examination of events leading up to the publication of Basel II, in which the hypotheses derived from my dynamic framework are tested through the method of process-tracing. Section V turns to the latest attempt to revise international capital adequacy standards: 'Basel III'. I argue that very same factors that caused Basel II's fail-

⁵ Jackson et al 1999, 22.

⁶ As Andrew Haldane, Executive Director for Financial Stability at the Bank of England, colourfully puts it: 'Basel vaccinated the naturally immune at the expense of the contagious: the celibate were inoculated, the promiscuous intoxicated.' *Financial Times*, 26 November 2009.

ure are now likely to prevent any meaningful progress for its successor.

II. THE FAILURE

The Basel Committee of Banking Supervision was established in 1974 at the Bank for International Settlements (BIS), a meeting place for central bankers created after the First World War. Until very recently, the Committee consisted of members of the Group of Ten (G10) plus Luxembourg and Spain, each represented by their central bank and the authority responsible for domestic banking supervision (where this is not the central bank).⁷ The original mandate of the Committee was to deal with the regulatory challenge posed by the increasing internationalization of banking in the 1970s. The collapse of the German Herstatt Bank and the New York-based Franklin National Bank in 1974 demonstrated that financial crises were no longer confined to one country, and that coordinated international action was needed to prevent future crises from spilling over borders.⁸ The Committee's first proposal, the 1975 Basel Concordat, established rules determining the responsibilities of home and host country regulators vis-à-vis cross-border banks.

The Committee's focus expanded in 1980s, as American regulators looked for a way to share the regulatory burden imposed on its banks after the Latin American Debt Crisis of 1982. To prevent future bailouts of American banks, the United States Congress had pushed domestic regulatory agencies to enforce a capital measurement system that required a fixed proportion of capital to be held against all exposures on banks' balance sheets. Ameri-

can banks subsequently complained that they faced a competitive disadvantage relative to less-regulated foreign banks, in particular Japanese banks, whose capital levels remained far lower.⁹ In response, American regulators seized on the Basel Committee to establish a common framework for the capital regulation of internationally active banks, the 1988 Accord on Capital Adequacy (Basel I).¹⁰

The 1988 accord set minimum capital requirements based on two ratios: a ratio of tier one (mainly equity) capital to risk-weighted assets of 4%; and a ratio of tier one plus tier two (undisclosed reserves, loan-loss provisions, subordinated debt) capital of 8%. Assets were risk-weighted according to the credit risk of the borrower – that is, the risk that the borrower will default on his loan. Government bonds, for example, had a 0% risk weighting, which entailed that no capital needed to be held against them. Traditional corporate loans, meanwhile, had a 100% risk weighting, which entailed that capital constituting the full 8% of the value of the loan must be held against it.

⁷ In March 2009 the Basel Committee decided to expand its membership to include all G-20 countries.

⁸ Wood 2005, 41; Tarullo 2008, 2.

⁹ Author's interview with former BCBS member, Oxford, October 2008.

¹⁰ BCBS 1988.

Table 1: Initial aims and regulatory outcomes.

	Initial Aim	Lobby	Recommendation	Final proposal
Internal Ratings	Incorporate external credit ratings into new framework	IIF	Recognize internal credit risk models of 'sophisticated' banks	Recognition of internal ratings for large banks in A-IRB approach
Trading Book	Introduce capital charge for derivatives risk ('w factor'); capture trading book risks	ISDA	Drop 'w factor'; do not apply credit risk capital requirements to trading book	'W factor' abolished in 2001; minimal regulation of trading book
Market Risk	Standardized methodology based on fixed risk parameters	IIF	Substitute standardized methodology for market risk (VaR) models	Recognition of VaR models in 1996
Securitization	Link risk weight categories to external credit ratings	ESF, ASF	Lower risk weights for rated tranches; greater use of internal ratings	Reduced weights for rated tranches; internal ratings for unrated tranches, liquidity facilities

By the late 1990s, the accord had come to be seen as a blunt instrument that was "useless for regulators and costly for banks."¹¹ Bankers lamented the gap between the actual risk inherent in assets and the regulatory capital assigned to them under the accord. Its crude risk buckets entailed, for instance, that a loan to a secure blue chip company was treated the same as a retail customer's overdraft, or that a loan to a large industrial country received the same capital charge as one to a volatile emerging market. This created perverse incentives to engage in regulatory arbitrage: exploiting the difference between economic risk and regulatory requirements to reduce capital levels without reducing exposure to risk. Banks arbitrated Basel I in two ways. First, they moved towards the

riskier, higher-yielding assets within a given risk bucket, for example from American to Korean government bonds. Second, they shifted assets off the balance sheet, typically securitizing them.¹² By securitizing a pool of loans and selling the tranches on to third parties with partial recourse or financial guarantees, banks were able to lower capital requirements while retaining the full risk associated with the original pool.¹³ The consequence of these activities was that overall capital levels in the banking system, which had risen sharply after Basel I came into effect in the early 1990s, were now beginning to decline.¹⁴

In September 1998 the Basel Committee announced that it would officially review the

¹² Securitization is a way of financing a pool of assets which involves transferring them to a third party conduit, usually a 'special purpose vehicle' (SPV), which then issues asset-backed securities that are claims against the asset pool.

¹³ Jackson et al 1999.

¹⁴ A July 1998 survey found that the average Tier I capital of the largest 1,000 banks made up only 4.48% of total assets, its lowest level since 1992. Cited in Wood 2005, 124.

¹¹ *Financial Times*, 22 September 1997, 4.

1988 accord with the aim of replacing it with more flexible rules. In June 1999 it released its first set of proposals for the new framework. According to the Committee, the new accord would have the following objectives: (1) The Accord should continue to promote safety and soundness in the financial system and, as such, the new framework should at least maintain the current overall level of capital in the system; (2) The Accord should continue to enhance competitive equality; (3) The Accord should constitute a more comprehensive approach to addressing risks.¹⁵

After five years of negotiations, notice-and-comment rounds, and impact studies, the Committee finally announced that it had agreed on a new capital adequacy framework, the Basel II Accord. The new accord rested on three 'pillars'. In addition to specifying minimum capital requirements (Pillar 1), the new accord provided guidelines on regulatory intervention to national supervisors (Pillar 2) and created new information disclosure standards for banks with a view to enhancing market discipline (Pillar 3).

The new accord was well received by bankers and regulators alike. Jean-Claude Trichet, Chairman of the G-10 group of central bankers, predicted that Basel II would "enhance banks' safety and soundness, strengthen the stability of the financial system as a whole, and improve the financial sector's ability to serve as a source for sustainable growth for the broader economy".¹⁶ Indeed, there appeared to be strong grounds for optimism. Under the 'advanced internal ratings-based (A-IRB) approach' in Pillar 1, banks for the first time were permitted to use their own models to estimate various aspects of credit risk, an innovation that would more closely align regulatory capital with underlying risk and thereby reduce the incentives

for arbitrage.¹⁷ Those without the resources to operate in-house models, meanwhile, would adopt the 'standardized approach', essentially a more refined version of Basel I which linked more fine-grained risk categories to external credit ratings provided by commercial rating agencies. The new accord also made strides in the area of securitization, where the Committee proposed a similar bifurcation of approaches, although this time with both making use of credit ratings. Finally, Basel II had the significant merit of moving beyond its predecessor's focus on credit risk, tackling the previously unregulated area of market risk, "the risk of losses in on- and off-balance sheet positions arising from movements in market prices."¹⁸ In this area, banks were encouraged to use sophisticated mathematical models to produce estimates of 'value-at-risk' (VaR), the probability that losses on a portfolio of financial assets will exceed a certain amount within a specified time horizon, for example \$1m over the next ten days.

As surveys have emerged showing the likely effects of Basel II, however, it has become painfully clear that the accord has failed to achieve any of its stated objectives. With respect to the first objective, every official 'Quantitative Impact Study' (QIS) conducted by the Basel Committee forecasts large capital reductions relative to Basel I levels for banks employing the A-IRB approach. The 2006 QIS-4, for instance, shows that these banks will experience an average drop in overall capital requirements of 15.5%, and a median reduction in Tier 1 capital of 31%.¹⁹ Estimates by individual super-

¹⁵ BCBS 1999.

¹⁶ *Financial Times*, 28 June 2004, 24.

¹⁷ The different aspects of credit risk include probability of default, expected loss given default, and exposure at default. Estimates of these are fed into a formula which determines the amount of capital that should be held against a given exposure.

¹⁸ BCBS 2004a. The market risk charge was incorporated into Basel I in the 1996 Market Risk Amendment. See BCBS 1996.

¹⁹ OCC, FRS, FDIC, and OTS 2006.

visors are no more encouraging. A 2003 study by the US Federal Deposit Insurance Corporation (FDIC) found that average capital levels in American banks adopting the most advanced approach would fall by 18-29%, with some seeing reductions of more than 40%.²⁰ Since the large banks likely to adopt this approach hold a significant share of the market, overall capital levels in the banking system are likely to decline, in explicit contradiction to Basel II's primary objective. On QIS-4 estimates, for instance, overall capital in the American banking system just prior to Basel II's formal implementation in 2007 would have fallen by as much as \$220bn.

The accord has also fallen short of its second stated objective, to continue to enhance competitive equality amongst banks. There are clear winners and losers under Basel II. Every QIS study shows large financial institutions under the A-IRB approach making significant gains on smaller institutions in terms of capital obligations. The 2006 QIS-5, for example, shows that A-IRB banks will experience a capital reduction of up to 26.7%, while those under in standardized approach will experience a 1.7% *increase* in overall capital requirements.²¹ Under Basel II, these larger institutions would be able to free up capital, expand their asset and boost profits, while other banks would be forced to undergo an opposite deleveraging process. This would almost certainly reduce the profitability of smaller banks, causing a loss of market share and making them more vulnerable to takeovers from larger banks. Indeed, a 2006 survey of over 300 banks by Ernst and Young found that 75% believed Basel II would benefit the largest banks employing the most advanced

risk modeling systems at the expense of those unable to adopt them.²²

Finally, the accord cannot be seen to constitute a more 'comprehensive' approach to addressing risks. Provisions for risks associated with the trading book are conspicuously absent, despite the Committee's awareness that the size of banks' trading books had mushroomed as a result of Basel I.²³ Even the treatment of new risks that the Committee *did* address was considerably watered down during the regulatory process. Banks were eventually allowed to use their own models to determine capital charges for market risk, even though market turmoil in the late 1990s had shown VaR models to vastly underestimate the probability of 'extreme' events. A similar shift towards self-regulation took place in the area of asset securitization, despite the Committee's recognition of Basel I's shortcomings in this area, with A-IRB banks being given permission to use their own estimates of the risk parameters for unrated exposures and liquidity facilities. Equally concerning are the extremely low levels of capital Basel II stipulates for highly rated securitization tranches – precisely those positions that incurred the biggest losses in the subprime mortgage crisis. According to QIS-5, A-IRB banks would experience a fall in securitization capital requirements of up to 17.3%, a figure that also has serious implications for the safety and soundness of the banking system (objective 1) and for the competitive equality that

²⁰ FDIC 2003.

²¹ BCBS 2006.

²² *Financial Times*, 10 April 2006, 23.

²³ The trading book is the portfolio of financial instruments held by a bank which (unlike assets held in the banking book) are purchased or sold on the stock market, whether to facilitate trading for its customers or to hedge against risk.

the Committee had aimed to achieve (objective 2).²⁴

Remarkably, the three objectives that formed the basis of the Committee's first consultative paper in 1999 were nowhere to be seen in the final version of the accord published in 2004. In their place are almost trivial new objectives, such as paying "due regard to particular features of the present supervisory and accounting systems in individual member countries" – objectives that the accord can more plausibly claim to achieve.²⁵

What explains the astonishing gap between the Committee's initial aims for Basel II and the final product of the regulatory process? In the next section, I look at three of the most popular theoretical approaches for understanding the outcomes of Basel process and ask whether they shed any light on the question of Basel II's failure. After highlighting the respective shortcomings of realist and liberalist theories, I turn to the most plausible of the three explanations: that Basel II's failure was the result of the excessive influence of large international banks in its creation.

III. REVIEWING THE LITERATURE ON BASEL II

Academic discussion of Basel II has largely focused on its potentially pro-cyclical impact on the macro-economy, its competitive implications for small- and medium-sized firms and emerging markets, and technical issues concerning the methodology for estimating credit risk in Pillar 1. As a result, the politics of the Basel process have been somewhat neglected. Only a handful of scholars have sought to identify the range of actors, resources, and in-

stitutions shaping decision-making outcomes in the Basel Committee. The few attempts to tackle these issues show a regrettable failure to provide systematic and accurate analyses of the Basel process and, above all, to explain the most salient feature of the process: the divergence between the aims of the Basel Committee and the final version of the accord.

We owe the most comprehensive examination of the politics of the Basel accords to Duncan Wood. In attempting to explain the 'driving forces' behind negotiations in the Basel Committee, Wood draws heavily on realist literature in the field of International Relations, focusing primarily on the distribution of power in the international economy and, specifically, the exercise of leadership by the United States.²⁶ As the most powerful member of the Committee, the United States has systematically pushed the interests of its domestic constituents ahead of its commitment to international financial stability. The result, argues Wood, is an accord skewed in favor of large American banks at the expense of other members of the Committee: "The ability of the United States to obtain international agreements that reflects its interests and those of its banks has been the single most important factor in determining outcomes in the Committee."²⁷ Unfortunately, this is far from the truth: there is little evidence of the United States playing the role of hegemonic leader that Wood casts for it. Indeed, American regulators have been heavily criticized in recent years by Congress for putting the nation's own regional banks at a competitive disadvantage – hardly the behavior of a hegemon bent on defending its national interests.²⁸ Basel II, contrary to Woods' assertions, does not promote the interests of individual

²⁴ BCBS 2006. For some banks the drop was as much as 43%.

²⁵ BCBS 2004a, 2, 4.

²⁶ Wood 2005, 2.

²⁷ *Ibid*, 163.

²⁸ See the House Financial Services Committee's comments to US regulators in 2003. *Financial Times*, 03 December 2003, 1.

members of the Basel Committee, but rather those of large international banks *regardless* of their national origin.

A second approach to analyzing the Basel process, favored by Edward Kane, Ethan Kapstein and Daniel Tarullo, builds on Robert Putnam's well-known model of international diplomacy as a 'two-level' game.²⁹ In its most basic formulation, the model predicts that governments will seek to reach an agreement at the international level that is likely to be accepted by a broad coalition of interest groups at the national level in a separate 'ratification phase'.³⁰ International agreements will occur when the 'win-sets' of negotiators – the sets of all possible agreements that would be ratified by a majority of domestic constituents – overlap with one another. In Kapstein's application of the model, Basel II reflects a compromise between private demands for a more level playing field due to the competitive distortions created by regulatory arbitrage under Basel I and public demands for a more stable financial system. Kane's analysis, meanwhile, emphasizes that demands for a level playing field came from small banks that could not afford to exploit the existing arbitrage opportunities. In the final accord, Kane suggests, these demands were balanced with the demands of larger banks for regulatory recognition of internal credit risk models. While usefully highlighting the role played by domestic actors in negotiations, these analyses nevertheless fail to provide a compelling account of the outcome of the Basel process. Contrary to the expectations of two-level models, Basel II did *not* satisfy a broad coalition of domestic interests across member countries; the accord favored one set of actors, namely large international banks, at the expense of all others. Failure to account for this outcome reflects a *misapplication* of the

two-level model rather than an inherent flaw in Putnam's conceptual framework. Basel II was not the product of interstate negotiations subsequently ratified by a coalition of domestic constituents, but the culmination of protracted discussions between a small group of unelected regulators with no political accountability and, crucially, whose decisions did not require independent ratification by domestic stakeholders. Under these very different conditions, as I explain in section IV, agreements will not reflect the preferences of a broad coalition of interests. In contrast, they will reflect the preferences of those actors that are first to arrive at the decision-making table.

A third and more promising analysis views Basel II as essentially the product of regulatory capture by large international banks in developed countries. Seeking to account for the inherent bias in the accord against low-rated sovereign, corporate, and bank borrowers – borrowers which predominately belong to developing countries – Stephany Griffith Jones and Avinash Persaud contend that Basel II was shaped by "the excessive influence by the large financial institutions domiciled in the countries represented on the Committee. The new accord is to their benefit and to the detriment of emerging market borrowers and developing countries not represented on the Committee."³¹ More recently, Stijn Claessens, Geoffrey Underhill and Xiaoke Zhang have made a similar argument: "...the [Basel] process was dominated by developed country supervisors involved in close relationships with major developed country financial institutions, suggesting capture of the policy process underpinning international supervisory cooperation. This provides a clear explanation as to why the needs of developing countries might be so poorly taken into account by the Basel Committee, despite the fact that the new accord has

²⁹ Putnam 1988; Kane 2007; Kapstein 2006.

³⁰ Putnam 1988, 434.

³¹ Griffith-Jones and Persaud 2003, 2.

major implications for supervisory practices and costs in markets around the globe.”³² By drawing attention to the possibility of regulatory capture, these authors take an important step towards explaining why regulators, despite setting out with the best intentions, may in the end fail to achieve their aims. Having said that, they stop short of presenting a full framework for the analysis of capture; the argument they present amounts to little more than an assertion of capture. As such, the authors leave important questions unanswered: Why do some policy processes restricted to G-10 countries *not* fall victim to capture? Why are some processes that succeed in incorporating a broad range of stakeholders still subject to capture? And why is it large international banks, rather than their smaller counterparts, that invariably manage to capture these processes? In order to answer these questions, it is necessary to systematically spell out the conditions under which capture occurred. In their absence, no firm conclusions can be drawn about the causes of Basel II’s failure. In the next section, I outline a framework that sets out these conditions.

IV. EXPLAINING THE FAILURE OF BASEL II

Overview of the analytical framework

The point of departure for my analytical framework is Walter Mattli and Ngaire Woods’ recent work on the politics of global regulation.³³ Mattli and Woods set out the broad conditions under which different regulatory outcomes are expected to occur in international rule-making, suggesting a plausible set of hypotheses about the factors facilitating capture in the Basel process. I argue, however, that the comparative-static analysis presented

by the authors fails to identify the most salient causal processes leading to capture – processes that can only be identified by appreciating the significance of *time* in international rule making.

Mattli and Woods start by drawing the distinction – only hinted at by scholars like Griffith-Jones and Persaud – between regulatory change that serves the common interest and regulatory change that benefits narrow vested interests as a result of regulatory capture. To understand when regulatory processes are more likely to produce one kind of change rather than the other, they argue, we must understand the institutional context in which rules are drafted, implemented, monitored, and enforced. An ‘extensive’ institutional context, characterized by open forums, proper due process, multiple access points, and oversight mechanisms, is less liable to be captured than a ‘limited’ institutional context that is exclusive, closed, and secretive. In this respect, Mattli and Woods have much in common with international legal experts, particularly in the emerging field of global administrative law, which represents the core of the ‘proceduralist’ school of global regulation.³⁴ For these scholars, the public interest is identified with a certain kind of regulatory process, namely one which meets certain standards of due process. As Mattli and Woods put it, “regulation is said to be in the public interest if it is arrived at through a deliberation process that allows everyone likely to be affected by it to have a voice in its formation”.³⁵

Affinities with the proceduralist school, however, end here. Mattli and Woods reject the idea that improvements on the institutional front alone are sufficient to secure common interest regulation. In addition to these supply-side conditions, certain ‘demand-side’

³² Claessens, Underhill and Zhang 2008.

³³ Mattli and Woods 2009.

³⁴ See Kingsbury, Krisch, and Stewart 2004.

³⁵ Mattli and Woods 2009, 13.

conditions must be satisfied in order to produce optimal regulatory outcomes. First, constituencies adversely affected by the *regulatory status quo* must have proper information about both the social cost of capture and the international regulatory agenda. Where powerful market players have a monopoly on information, whether through better organization or personal contacts with regulators, they will have little trouble securing their preferred outcomes. Second, these constituencies must be supported by public or private ‘entrepreneurs’ providing technical expertise, financial resources, and an organizational platform for them. Finally, and crucial to the success of public-private alliances, is a shared set of ideas about how to regulate around which diverse actors can unite in a pro-change coalition.

It is only when *both* supply and demand conditions are met that regulatory change in the common interest is possible. An ‘extensive’ regulatory forum, contrary to proceduralist claims, is not enough. Indeed, Mattli and Woods’ project can be thought of as an attempt – just as Ernst Haas did for functionalism in the early 1960s – to ‘bring the politics back in’ to proceduralism. I suggest, for this reason, that their approach should be labeled the *neo-proceduralist* school of global regulation. Regulatory outcomes, on this view, are defined not only in terms of the procedure that generates them, but also the range of societal input into that procedure.

By moving beyond the naïve assumptions of proceduralism, Mattli and Woods have undoubtedly advanced the study of international regulatory processes. What they have failed to do, however, is identify the salient causal mechanisms that link supply- and demand-side factors to regulatory outcomes. To identify these mechanisms, we must pay attention to *key temporal* dimensions of regulatory processes that are lost in the ‘snapshot’ view of comparative-static analysis. In other words, we must con-

ceive of capture as a cumulative process that unfolds over time – and not one that occurs in decontextualized isolation. The analytical gain from this shift in focus is significant: recognizing that events or processes are rooted in a particular temporal context sensitizes us to crucial causal effects that are essentially invisible from an ahistorical point of view.³⁶ The introduction of time into the framework, then, will allow us to preserve the important insights of the neo-proceduralist framework while at the same time constructing more accurate hypotheses about supply- and demand-side variables in the Basel process.

What exactly do we gain from contextualizing the framework? The answer lies essentially in the demand side of the framework. Recognizing that regulatory processes take place in time gives us a better understanding of how actors with a comparative informational lead are able to convert this advantage into concrete regulatory outcomes. Specifically, the reason that the better-informed are able to exercise such a disproportionate degree of influence over the regulatory process is that they are able to claim ‘first-mover advantage’ – they are the first to arrive at the decision-making table. This gives them enormous leverage at critical junctures in the regulatory process, since policy decisions made at an early stage tend to be self-reinforcing. Once a particular path has been chosen, we are often reminded by economists, each step down that path increases the probability of further steps, as the relative benefits of the current activity compared with once-possible options increase over time. It becomes more and more difficult, meanwhile, for latecomers to reverse the trend. As Paul Pierson argues, “If early competitive advantages may be self-reinforcing, then *relative timing* may have enormous implications ... groups able to consolidate early advantages may achieve enduring

³⁶ See Pierson 2004.

superiority. Actors arriving later may find that resources in the environment are already committed to other patterns of mobilization.³⁷ In the case of Basel II, then, our neo-proceduralist framework leads us to expect those with the best information about the Basel Committee's agenda – large international banks – to gain first-mover advantage in negotiations for the new accord, allowing them to shape decisions in a way that is increasingly difficult to reverse at later stages.

Having good information, however, is not the same as having abundant material resources. In the case of Basel II, for instance, the five or so American banks with the greatest influence on the accord – through their pre-eminent position in powerful international banking lobbies – had a combined deposit market share of only 36% in the United States.³⁸ It was not their resources *per se* that were key to their success in shaping the accord, but, as it will later become clear, the timing of their involvement in the regulatory process – a very different kind of advantage that was based on the personal contacts they had amongst regulators. In this respect, my analysis is not just a thinly-veiled recourse to realism. Nor is it a recourse to historical institutionalism. The question of who arrives first is not a matter of chance, but a function of the distribution of information amongst actors. More importantly, unlike scholars like Pierson, I do not take 'time' to be an analytically salient variable in *all* circumstances. Early participation only matters under certain conditions, namely when negotiators have little accountability to domestic constituents – almost always the case in technical matters such as capital adequacy

standards. First-mover advantage is of little consequence, on the other hand, in the more familiar 'grand bargains' between states in the realms of security and trade. Here, as suggested in Section III, negotiators are subject to a crucial constraint: any agreement they reach must be endorsed by their constituents in a separate ratification phase.³⁹ This effectively nullifies any advantage gained from early participation, since any deal reached by negotiators can be later rescinded by concerned domestic groups. Spelling out the conditions under which first-mover advantage matters, therefore, is not to deny the importance of organized lobbying power in global regulatory processes; rather, it is to explain what this power *is* in the different institutional contexts in which rule making takes place.

To summarize, the central claim of my analysis is that neo-proceduralism can be strengthened as an analytical framework of global regulatory processes by proper temporal contextualization. Where agreements reached at the international level are subject to domestic ratification, each party's timing has little import. But where agreements lack a distinct ratification phase, timing takes on enormous significance. In the case of Basel II, large international banks are expected to use their privileged access to information about the Basel Committee's agenda to arrive first at the decision-making table and influence the content of the accord at a critical stage of proceedings. Those arriving later will struggle to have any bearing on negotiations, facing an increasingly entrenched set of proposals. It should be noted that contextualizing the framework does not render supply-side factors irrelevant to the analysis. A lack of due process can prejudice public groups as much as a lack of early information, leading to capture regardless of how well-informed they may be. Further, limitations

³⁷ *Ibid.*, 71.

³⁸ Calculated with data from the FDIC's 2008 Summary of Deposits, available at <<http://www2.fdic.gov/sod/index.asp>>. Accessed 14 August 2009. The five banks are Bank of America, JPMorganChase, Wells Fargo, Citigroup, and State Street.

³⁹ Putnam 1988, 436.

on the supply-side can often exacerbate the problems faced by groups with a pre-existing informational disadvantage. The point merely is that the neo-proceduralist analysis offered by Mattli and Woods cannot fully illuminate the mechanisms by which capture takes place without recognizing the importance of timing and sequencing on the demand-side. Whether or not these mechanisms operate as stipulated and whether or not they help us to better understand the case of Basel II, is something we can test only through a detailed investigation into how the Basel process unfolded. This is what I turn to in the next section.

Why Basel II failed: An in-depth examination of the regulatory process

In order to test my account of Basel II's failure, I propose to use the method of process-tracing. A close examination of Basel Committee documents, press releases, interview transcripts, and other sources will help to determine whether the specific causal mechanisms implied by the theory are in fact evident in the sequence of events comprising the Basel process.⁴⁰ The first part of this section focuses on the Basel Committee's failure to achieve its first and second aims for the accord, the result of its decision to allow wealthy banks to use internal ratings. The second part will turn to the third aim, and the developments in the treatment of market risk, the trading book, and securitization that caused Basel II to fall short of providing a more 'comprehensive' approach to risk management.

Before the investigation begins, a word on institutional context. As suggested in the previous section, although the analytical framework I presented emphasizes demand-side factors, it is nevertheless important to be aware of the institutional setting in which the Basel process took place, and the role that the supply-side

played in reinforcing power asymmetries created on the demand side. In short, the Basel Committee of 1999-2004 had one of the worst records of all international standard-setters in terms of transparency, representation, and accountability.⁴¹ The Committee's meetings (which occurred four times per year) were closed to the public, with no record of who was present or what was discussed.⁴² The frequent discussions with outside interests, in particular the banking industry, were also off-the-record and took place on a relatively informal basis. It is much the same story for subcommittee meetings. Under the main Basel Committee, there were four policy groups in charge of fourteen subcommittees working on different aspects of the accord.⁴³ It is in these subcommittees that much of the technical work was done, often in close consultation with industry experts.⁴⁴ Despite their importance, it is only recently that *any* information has been disclosed about these committees, and even this is limited to

⁴¹ See the Global Accountability Report (Blagescu and Lloyd 2006). The BIS has one of the lowest scores on its index of transparency (28%), participation (11%), and complaint and response mechanisms (33%).

⁴² Author's interview with former BCBS member, London, December 2008.

⁴³ Author's interview with former BCBS member, London, December 2008. The four subgroups are the Accord Implementation Group, the Policy Development Group, the Accounting Task Force, and the International Liaison Group.

⁴⁴ Legal scholars, such as Michael Barr and Geoffrey Miller, have pointed to the Committee's introduction of notice-and-comment rounds as evidence of "a structure of global administrative law inherent in the Basel process that could be a model for international rule-making with greater accountability and legitimacy" (Barr and Miller 2006, 17). However, these procedures are no substitute for transparency about the regulatory agenda. As I show in the next section, as early as the first round of consultation in the Basel process many of the key decisions about the content of the new accord had already been made.

⁴⁰ George and Bennett 2005, 6.

the name of the group, its chair, and its position in the organizational chart.⁴⁵

With respect to representation, despite consciously creating global standards, it is only in 2009 that the Basel Committee chose to open its gates to developing countries. During negotiations for Basel II, even observer status was extended only to the European Commission (EC) and the European Central Bank (ECB). Committee members are quick to point to the work of the International Liaison Group and its two subcommittees, which represented the interests of important emerging markets during the negotiations. But as authors like Griffith-Jones and Persaud argue, there is only so much influence that these countries could exercise without formal representation on the Committee.

Finally, few mechanisms existed for holding the Basel Committee to account. Unlike organizations like the United Nations, there are no *post-facto* accountability exercises which allow public groups to question the Committee's success in terms of its own goals. Since its members are drawn from regulatory agencies rather than governments, they are relatively insulated from executive and legislative control domestically. Once appointed, they tend to have a high degree of operational independence and are typically subject to little legislative oversight. At the international level, the Basel Committee answers only to a G-10 Group of Central Bank Governors and Heads of Supervision, with whom it meets once per year. Eight members of this group have either no responsibility for banking supervision or only a supporting role.⁴⁶ Only recently have the governors convened a group of heads of supervision, and even this is limited to an advisory role. Even members of the Committee

have expressed reservations about this arrangement. Howard Davies and David Green, for instance, lament that the G-10 Governors have been more concerned with guarding their control of the Committee than monitoring its activities, insisting that its chair be a central bank governor even when there are no candidates with appropriate experience and domestic responsibilities.

As we will see in the rest of the section, the Committee's failure to meet basic standards of due process had important implications for Basel II. It reinforced the deep information asymmetries on the demand side that allowed international G-10 banks to claim first-mover advantage in negotiations. For community banks, developing country banks, and public groups with a stake in the new accord, the consequences were devastating.

Internal ratings

The Basel Committee's decision to create an A-IRB approach to credit risk represents perhaps the clearest example of regulatory capture in the Basel process. It should be clear by now that the attraction of internal ratings for large international banks lies in their perceived impact on capital requirements. For two reasons, internal ratings are likely to lead to large capital reductions for banks employing them. First, they are largely derived from historical data, which tend to suggest that the capital that should be held against certain types of assets is much lower than that stipulated by Basel I. The problem with this method of calculation is that the historical default rates of asset classes are often poor indicators of future default rates.⁴⁷ Indeed, during financial crises assets which were previously uncorrelated tend to become correlated, generating much larger losses than anticipated. Second, despite being intro-

⁴⁵ Information available at < <http://www.bis.org/bcbs/index.htm> >. Accessed 14 August 2009.

⁴⁶ Davies and Green 2008.

⁴⁷ Author's interview with former BCBS member, Oxford, December 2008.

duced to reduce regulatory arbitrage, internal ratings ironically provide banks with an even easier way of lowering capital without lowering risk. The incentive to game capital regulation is all the stronger for systemically important institutions which can expect a government bailout in the event of insolvency.

The decision to create an approach based on internal ratings was heavily influenced by developments in the initial stages of the Basel process. At the centre of these developments was the Institute of International Finance (IIF), a powerful Washington-based consultative group of major US and European banks seeking to “promote outcomes that are beneficial to the global financial industry”. The institute had long enjoyed a close relationship with the Basel Committee based on its personal contacts in national regulatory agencies. The longest-serving Chairman of the Basel Committee, the Bank of England’s Peter Cooke (1977-88), was in fact one of the co-founders of the IIF.⁴⁸ The Chairman of the Committee in the mid-1990s, the Bank of Italy’s Tommaso Padoa-Schioppa, was a close associate of Charles Dallara, Managing Director of the IIF since 1993. Indeed, it was after meeting at a social occasion in March 1995 that the two agreed to establish an ‘informal discussion’ on regulatory issues between financial institutions and bank supervisors. This led to close cooperation between the two bodies in the negotiation and implementation of the Market Risk Amendment in 1996 (see below), with representatives of the Committee’s Models Task Force meeting with IIF several times under agreed ‘ground rules’ of strict confidentiality. These links became even stronger under the Chairmanship of William McDonough (1998-2003), a President of the New York Federal Reserve who presided over almost all of the Committee’s work on Basel

⁴⁸ Author’s interview with former BCBS member, Oxford, December 2008. The IIF was founded in 1983.

II.⁴⁹ Another close friend of Dallara’s from his 22 years at the First National Bank of Chicago, McDonough gave the IIF unprecedented access to the Committee from the earliest stage of the reform process. The institute even went as far as to establish a Steering Committee on Regulatory Capital in June 1999 specifically to make recommendations to the Committee about the new accord. The Steering Committee remained the Basel Committee’s principal interlocutor throughout negotiations, with its two working groups helping many of the Basel subcommittees to draft different parts of the accord. The advantages of timely access to the Committee were clear from the beginning of the Basel process. As early as the Second Consultative Paper in 2001 the IIF was able to identify seven different areas in which the Basel Committee had adopted its recommendations.⁵⁰

One of these areas was the introduction of an internal ratings-based approach to credit risk. The IIF had lobbied aggressively for greater recognition of banks’ own risk measurement systems since as early as November 1997. These systems, the group argued, were not only more risk-sensitive than Basel I’s arbitrary risk weights, but had the crucial advantage of being already in use by banks.⁵¹ This proposal was initially met with skepticism by regulators. At the September 1998 conference at which the Committee announced its agenda for revising Basel I, Bank of England staff stated that there were “significant hurdles” to using internal sys-

⁴⁹ Author’s interview with former BCBS member, New York, January 2009.

⁵⁰ IIF 2001a. The most frequent meetings with banking executives appear to have been conducted by the Federal Reserve trio of William McDonough, Roger Ferguson, and Darryll Hendricks – all of whom had a private-sector background and went on to work at major banks after leaving the Basel Committee. Author’s interview with former BCBS member, Washington D.C. January 2009.

⁵¹ See IIF 1997.

tems to set capital requirements.⁵² Similarly, a study by two Federal Reserve economists found the state of ratings systems in large American banks far less advanced than had been widely assumed.⁵³ Nevertheless, by the release of the first consultative paper for the new accord the IIF had succeeded in convincing enough of the Committee of the merits of an A-IRB approach to credit risk for “some sophisticated banks”.⁵⁴ There were, however, only a few paragraphs devoted to the idea, and the focus of the paper was how *external* ratings provided by credit rating agencies would be formally incorporated into the accord. What changed between the release of the first paper in June 1999 and the second in January 2001, in which a full specification of a new A-IRB approach was given?

The answer lies in the persistent lobbying of the IIF, which took advantage of its intimacy with the Committee to ensure that the advanced approach, almost an afterthought in the first paper, became a reality. During 2000, the Steering Committee published a report specifically urging the Basel Committee to permit banks to use their internal risk rating systems as a basis for assessing capital requirements. Sir John Bond, then Chairman of the IIF, suggested that the measure was “important for enhancing the competitiveness of banks by bringing individual banks’ capital requirements more in line with actual risks”.⁵⁵ Revealingly, a credit risk manager at the UK’s Financial Services Authority (FSA) at the time admitted that “more regulators around Europe are coming round to the view that a large number of banks should be able to qualify for internal ratings”.⁵⁶ By mid-2000, it seems, every member of the Basel Committee had come around to the IIF’s

view, and the working group on credit risk began informal work with the IIF to incorporate internal ratings into the new framework.⁵⁷ The second draft’s detailed exposition of the A-IRB approach was “broadly welcomed” by the IIF Steering Committee as one of the many areas in which its recommendations had been taken on board.⁵⁸

By the time small and non-G10 banks became aware of the likely impact of these developments, the release of the second consultative paper in 2001, negotiations were at such an advanced stage that an overhaul of the Committee’s proposals was near impossible. As the vice president of ICBA, a leading association of American community banks, put it, “We didn’t get involved until quite a late stage... And when we did, the modeling (A-IRB) approach was already set in stone. The [Basel] Committee had been convinced by the large banks.”⁵⁹ The few comments on the paper left by small banks reflected serious apprehension about the potential competitive inequities of Basel II. Amongst the loudest voices were the Second Association of Regional Banks, a group representing the Japanese regional banking industry, and Midwest Bank, an American regional bank catering to consumers in Missouri, Iowa, Nebraska, and South Dakota. The latter protested that the few banks qualifying for the A-IRB approach “will not be required to keep the same level of capital against financial instruments as 99% of the financial institutions in this nation who cannot qualify under these standards”.⁶⁰ These concerns were perhaps best expressed by America’s Community Bankers

⁵² Jackson, Nickel, and Perraudin 1999, 100.

⁵³ Treacy and Carey 1998.

⁵⁴ BCBS 1999, 37.

⁵⁵ *Financial Times*, 13 April 2000, 13.

⁵⁶ *Ibid.*

⁵⁷ Author’s interview with former BCBS member, Washington D.C., January 2009.

⁵⁸ Available at <<http://www.bis.org/bcbs/ca/iistctonreca.pdf>>. Accessed 15 October 2008.

⁵⁹ Author’s interview with vice president of community bank associatio, Washington D.C., January 2009.

⁶⁰ Available at <<http://www.bis.org/bcbs/ca/midindbk.pdf>>. Accessed 15 October 2008. P.1, para 4.

(ACB), another group representing community banks across the United States. The ACB made a strong case for the claim that “the Accord will benefit only the most complex and internationally active banks, saddling the vast majority of financial institutions in the United States with a cumbersome and expensive capital regulatory scheme ...”⁶¹ This was most pronounced, the group claimed, in Pillar 1, where “the proposed bifurcation between the standardized and internal ratings-based approaches to establishing minimum capital requirements will competitively disadvantage many smaller banking institutions that lack the resources necessary for developing a finely calibrated IRB assessment system”.⁶²

Competitive fears were not confined to community banks. Several important emerging markets also expressed fears that they would be disadvantaged under the new arrangements. Commenting on the 2001 second consultative paper, the Reserve Bank of India complained that, by failing to qualify for internal ratings, emerging market banks would experience a “significant increase” in capital charges.⁶³ The People’s Bank of China, meanwhile, suggested that the proposals “basically address the needs of large and complex banks in G10 countries”.⁶⁴ Similar worries were articulated by the Banking Council of South Africa, which pointed out that while “the Accord aims at ‘competitive equality’, the bigger, more advanced banks may have access to options that will give them a market advantage, whereas the smaller banks may find it difficult to afford the necessary in-

frastructure investments”.⁶⁵ Like the objections of community banks, however, these came too late to influence proceedings. The idea of discarding years’ worth of work on developing the A-IRB approach could not be taken seriously, especially by a Committee already under fire for delaying the implementation of Basel II. It is no surprise that when a group of five major emerging markets protested about the accord’s competitive implications at a behind-closed-doors meeting in Cape Town in 2002, it was accused by Chairman McDonough of attempting to “derail the whole process”.⁶⁶ By this stage, the recognition of internal ratings was a well-established feature of Basel II. Indeed, only very minor changes were made to Pillar I’s credit risk approaches between 2001’s second consultative paper and the final version of the accord published in 2004.

Trading book, market risk, and securitization

The Committee’s failure to achieve its third aim, to create a more comprehensive approach to risk management, can be traced to changes made both during negotiations for Basel II and in the mid-1990s shortly after Basel I came into effect.

Basel II’s light treatment of the trading book had much to do with the International Swaps and Derivatives Association (ISDA), the largest global financial trade association, representing over 860 institutions in the privately-negotiated derivatives industry. As one of the first organizations to comment on drafts of the new accord, the ISDA managed to persuade the Committee to defer to its ‘better’ judgment on several trading book issues, most importantly in its September 2001 decision to drop its initial proposal for an additional capital charge to

⁶¹ Available at < <http://www.bis.org/bcbs/ca/amcobare.pdf>>. Accessed 15 October 2008. P.2, para 2.

⁶² Ibid, p.2, para 3.

⁶³ Available at < <http://www.bis.org/bcbs/ca/rebkofin.pdf>>. Accessed 15 October 2008. P.2, para 2.

⁶⁴ Available at <<http://www.bis.org/bcbs/ca/pebkofch.pdf>>. Accessed 15 October 2008. P.2, para 2.

⁶⁵ Available at < <http://www.bis.org/bcbs/ca/thbacosoaf.pdf>>. Accessed 15 October 15 2008. Article 2.12, para 6.

⁶⁶ Author’s interview former BCBS observer, Washington D.C. January 2009.

cover the various risks associated with credit derivatives. The ISDA had forcefully lobbied against the measure, dubbed the ‘w factor’, on the grounds that it was “unjustified in light of market practice: losses experienced on repo or credit derivatives trades had been minimal, and the contracts used to document the transactions were enforceable and effective”.⁶⁷ The Committee’s reversal, as the *Financial Times* noted at the time, was at odds with concerns recently expressed by its members about the way banks were dealing with exposure to the derivatives market and the possibility that the structure of these instruments tended to *concentrate* risk rather than dispersing it, as they are in theory meant to do.⁶⁸

The ISDA also had a hand in the Committee’s reluctance to regulate those trading book risks that were not captured by standard market risk models, in particular counterparty credit risk. The Committee’s trading book working group, which worked closely with the ISDA, bought into the association’s argument that “the assumptions regarding the calibration of credit risk requirements in the banking book may not be appropriate for trading book exposures, which are typically short-term in nature, more liquid, and marked-to-market”.⁶⁹ As one former member of the Committee admitted, “We went too far on capital relief for the trading book. We were convinced by the industry that [instruments in the trading book] needed a lower capital charge because they were more liquid ... In good times, it’s hard to go against the banks.”⁷⁰ The subprime mortgage crisis has shown this argument to be fatally flawed, with the heaviest losses on highly illiquid and opaque trading book instruments. In the end, the section devoted to the trading book was

one of the shortest in the 2004 final accord. Accusations of regulatory forbearance, which grew louder in 2004, once again came too late.⁷¹ While the Basel Committee was forced to admit that increased capital charges for trading book risks were needed, given “the complexities of the trading book issues to be discussed”, it was willing only to defer reform to a later date.⁷²

The only aspect of the trading book that the Committee made a concerted effort to tackle was market risk, albeit in the mid-1990s rather than during official negotiations for Basel II. Even in this area, though, proposals were significantly watered-down in the face of industry pressure. In 1993, the Committee proposed to amend the 1988 accord to incorporate market risk, largely in response to the deregulation of interest rates and capital controls, which had increased banks’ vulnerability to market fluctuations. The 1993 paper proposed a standardized methodology for measuring market risks which calculated capital requirements on the basis of certain characteristics of debt securities and derivatives, such as maturity, credit rating, and category of borrower.⁷³ These proposals were met with strong opposition from the IIF, who maintained that they failed to provide sufficient incentives to improve risk management systems by not recognizing the most sophisticated modeling techniques already in use.⁷⁴ The IIF was soon joined by the Group of Thirty, a Washington-based association of senior bankers, which backed VaR models as “much more analytically rigorous than the old rules of thumb that bankers used to use”.⁷⁵ Although at first reluctant to consider the use of VaR models, regulators began to give serious

⁶⁷ *Financial Times Online*, 25 September 2001.

⁶⁸ *Ibid.*

⁶⁹ Available at <<http://www.bis.org/bcbs/ca/isdaresp.pdf>>. Accessed 15 October 2008. Article 6, para 1.

⁷⁰ Author’s interview with George French.

⁷¹ *Financial Times*, 18 February 2004, 22.

⁷² *Ibid.*

⁷³ BCBS 1993.

⁷⁴ IIF 1993.

⁷⁵ *Financial Times*, 7 September 1994, 21.

attention to the proposal after the establishment of a formalized dialogue with the IIF in early 1995 (see above). By April 1995, the Committee fully endorsed the IIF's proposals, officially recognizing the use of in-house VaR models in a consultative paper entitled "An Internal Model-Based Approach to Market Risk Capital Requirements".⁷⁶

This was a surprising development given the 'quite disparate' results from the Committee's testing exercise, which showed significant overall dispersion in capital charges for the same trading book, even after the apparent factors causing systematic differences in model output were controlled for.⁷⁷ It was also surprising given the serious doubts about these models that began to surface in 1995, such as the rating agency Standard and Poor's warning in 1995 that the models only "appear to offer mathematical precision" and that "they are not a magic bullet".⁷⁸ Most surprising, though, was the fact that these models passed into Basel II without question. At the time the Committee was formulating its first draft accord in early 1999, banks were reporting widespread losses on Russian government bonds that were entirely unanticipated by their VaR models. Bankers Trust, an American wholesale bank, reported that on five days during the latest quarter its trading account losses had exceeded its one day 99% VaR calculation, a figure that statistically should be exceeded on just one day in a hundred.⁷⁹ J.P. Morgan, too, reported that daily trading results had fallen below average far more often than its market risk models had predicted. Most damningly, a report published by the International Monetary Fund (IMF) in December 1998 had condemned VaR models for paying "insufficient attention" to extreme

market events and assuming that the processes generating market prices were stable.⁸⁰ But despite widespread and persistent criticism, no questions were raised within the Committee about the continued use of VaR models in 1999.

Basel II's failure to create a more comprehensive approach to risk management also stemmed from its lenient treatment of asset securitization. Assigning a suitable capital charge for asset-backed securities was high on the Basel Committee's list of priorities, not least because of their central place in the 'originate and distribute' model so effectively employed by banks to arbitrage Basel I standards. Once more, however, the Committee's initial tough stance was gradually eroded by determined industry groups. The earliest arrivers, which worked closely with the Committee's working group on asset securitization, were large forums for banks specializing in the trade of off-balance sheet instruments, in particular the European Securitization Forum (ESF), the American Securitization Forum (ASF), and the ISDA.⁸¹ These forums persuasively argued that securitization facilitates prudent risk management and diversification by providing an efficient means for banks to redistribute their risks to those most willing to bear them. Securitization, the ESF claimed, "has proven itself to be a source of safe, fixed income assets from the perspective of banks as investors".⁸² The credibility of these claims, of course, has been shattered by the subprime mortgage crisis. Nonetheless, the Committee heavily diluted its securitization proposals during negotiations for Basel II, requiring progressively less capital for the same exposures and allowing banks to set capital charges in several areas on the basis

⁷⁶ BCBS 1995.

⁷⁷ *Ibid.*, 5.

⁷⁸ *Financial Times*, 12 April 1995, 19.

⁷⁹ *Financial Times*, 29 January 1999, 3.

⁸⁰ IMF 1998.

⁸¹ Author's interview with former BCBS member, London, December 2008.

⁸² Available at <<http://www.bis.org/bcbs/ca/eursecfor2.pdf>>. Accessed 15 October 2008. P.4, article 1, para 1.

of internal ratings. It even began to adopt the securitization industry's language, reiterating in several proposals that "the Committee recognizes that asset securitization can serve as an efficient way to redistribute the credit risks of a bank to other banks or non-bank investors".⁸³

In its first draft in 1999, the Basel Committee proposed to directly tie capital charges for securitization tranches to external credit ratings. For all banks, tranches rated AAA or AA- would carry a 20% risk weight, A+ to A- a 50% weight, BBB+ to BBB- 100%, BB+ to BB- 150%, and B+ or below a deduction from capital. The Committee was soon persuaded by the ESF to devise a separate approach for A-IRB banks to "take advantage of the greater capacity for risk-sensitivity under the internal ratings-based framework".⁸⁴ Outlined in the 2001 second consultative paper, an advanced approach would permit banks to use their own estimates of probability of default for unrated exposures. Further steps towards self-regulation were taken January 2004, as the Committee acted on the forums' request for an internal ratings-based approach for liquidity facilities extended to asset-backed commercial paper conduits.⁸⁵ "It is evident," said a member of the ESF and ASF's regulatory committees in March 2004, "that [the Basel Committee] have been listening. At the start of the process there were some hurdles..." – hurdles which no doubt had been successfully negotiated.⁸⁶ Both of these measures, however, gave A-IRB banks further scope to game capital requirements and gain a competitive edge on smaller banks, enhancing the privileged position al-

ready conferred on them by low-credit risk requirements.

The approach's treatment of *rated* positions, however, was the subject of intense industry opposition from an early stage. In 2001, the ESF complained that the prescribed risk-weights for rated tranches were "excessive", arguing that they should never be higher than identically-rated conventional corporate exposures.⁸⁷ After the IIF stepped in to back the ESF's claim, protesting that the "proposal's recommended treatment of securitization activities is too stringent and risks disrupting the valuable aspects of existing activities", the Committee acquiesced, almost halving the risk-weights for rated tranches to link them with corporate exposures with similar default probabilities.⁸⁸ In the next two years, further reductions were made to the risk weights after consultation with the securitization forums, reflecting the risk-mitigating effects of features such as 'pool granularity' that the Committee's own specialists had apparently overlooked. By the final paper in 2004, they had reached dangerously low levels. Risk weights for the senior positions of tranches rated AAA would be 7%, AA 8%, A+ 10%, A 12%, BBB+ 35%, and BB 60%. The risk weights for rated tranches under the standardized approach, meanwhile, remained the same as in the 1999 first draft. This was a startling reversal. The inadequate treatment of securitization, after all, was one of the main motivations for updating Basel I in the first place. It is hard to resist the conclusion that, had a different set of actors been first on the scene, securitization proposals would have reflected a much broader set of preferences.

A detailed examination of the Basel process, then, provides very strong evidence for the

⁸³ BCBS 1999.

⁸⁴ BCBS 2001, 13.

⁸⁵ BCBS 2004b.

⁸⁶ Risk, March 2004.

⁸⁷ Available at < <http://www.bis.org/bcbs/ca/eursecfor2.pdf>>. Accessed 15 October 2008.

⁸⁸ Available at <<http://www.bis.org/bcbs/ca/iwgoncaad.pdf>> 111. Accessed 15 October 2008. P.111, article 10; BCBS 2001.

capture hypothesis. On the demand side, as we have seen, comparative informational advantages gave large international banks first-mover advantage in negotiations for Basel II, allowing them to mould proposals in an often irreversible way. Community and non-G10 banks arrived too late to have a meaningful say in the content of the accord. Their difficulties were compounded by limitations on the supply side, which ensured both that they received minimal information and that the decision-making table was ‘full’ at an early stage of proceedings. The consequence, unfortunately, was that the final accord failed to achieve its initial aims.

V. IMPLICATIONS FOR THE FATE OF ‘BASEL III’

Beginning in the subprime mortgage market in the United States in the summer of 2007 and quickly spreading to Europe and the rest of the world, the recent financial crisis has passed perhaps the most damning verdict of all on Basel II. Whether or not they view Basel II as a direct contributor to the crisis, supervisors have agreed that the fundamental tenets of the accord – reliance on internal risk models, capital relief for the largest banks, and minimal regulation of the trading book – have been all but discredited by recent events. Indeed, something of a consensus has arisen in policy-making circles that a new approach to capital regulation is essential to the future stability of the global financial system. The Financial Stability Forum (FSF), an influential group of finance ministers and central bankers, issued a post-mortem on the crisis in 2008 criticizing the “inadequate” capital buffers held against securitized assets and urging regulators to address the “significant weaknesses” in the existing capital framework.⁸⁹ The February 2009 Larosière Re-

⁸⁹ FSF 2008, 12.

port, a framework for the future of European financial regulation, demanded “fundamental review” of Basel II on the grounds that it “underestimated some important risks and overestimated banks’ ability to handle them”.⁹⁰ The Financial Services Authority’s much anticipated Turner Review called for regulatory minima to be “significantly increased from [the] current Basel II regime”.⁹¹ These efforts culminated in a ‘regulatory tsunami’ of new and far-reaching proposals issued by the Basel Committee in December 2009, already dubbed ‘Basel III’.⁹² Due to be finalized by the end of the 2010, the reform package has shaken the finance industry and in some eyes heralded a new era in the history of banking regulation – an era of “more resilient banks and a sounder banking and financial system”.⁹³

Such conclusions, I argue in this section, are too hasty. Many of the same factors that led to Basel II’s failure, my neo-proceduralist analysis warns, may now be contributing to the demise of its successor. Despite the immense political will behind an overhaul of the global financial system, it is once again large international banks that have seized control of the regulatory process, potentially closing the window of opportunity for far-reaching reform. The first part of the section describes the favorable societal and institutional conditions under which ‘Basel III’ was conceived: strong public demand for regulatory change in global finance and a migration of regulatory authority from the Basel Committee to the G-20. In the second part of the section, I show how changes to these conditions in late 2009 lead us to very different expectations about the fate of ‘Basel III’. In the final part, I offer compelling evidence, drawing on events of recent months, that large interna-

⁹⁰ De Larosière et al 2009, 16.

⁹¹ FSA (2009), 54.

⁹² *Global Risk Regulator*, December 2009, vol. 7: issue 11.

⁹³ Available at < <http://www.bis.org/press/p091217.htm>>. Accessed 22 April 2010.

tional banks are already enjoying some success in diluting the Committee's reform proposals. Far from a new dawn for banking regulation, this evidence lends strong support to the view that history may be about to repeat itself.

The origins of 'Basel III'

To understand how large financial institutions have been able to regain control of the Basel process, we have to return to the origins of 'Basel III' in late 2008. The unexpected collapse of investment bank Lehman Brothers in September saw the financial crisis spill over into the real economy. GDP growth in the Euro area ground to a halt in the third quarter of 2008 and fell to -1.3% in the fourth; in the United States, 0.9% growth in the second quarter turned into 0.3% in the third and -1.3% in the fourth.⁹⁴ With public anger at the financial sector mounting and banking regulation becoming an increasingly politicized issue, capital adequacy standards soon became the prerogative of the G-20. This was a development with significant implications for neo-proceduralist theory. On the supply side, the G-20, unlike the Basel Committee, is a forum comprised of elected political leaders whose well-publicized agendas, meetings, and working groups are all open to public scrutiny. On the demand side – and especially important from the perspective of my analysis – it is a forum in which potential agreements are subject to a ratification phase. Since any deal reached between negotiators can in theory be later rescinded by their domestic constituents, early participation in the regulatory process does *not* constitute a decisive advantage. Agreements reached by the group are therefore shaped not by the enduring influence of early arrivers, but instead by

the comparative-static supply- and demand-side factors identified by Mattli and Woods.

In line with Mattli and Woods' theoretical expectations, the combination of extensive institutional supply and strong public demand for regulatory change in the wake of the crisis transformed the G-20 into an effective advocate for capital adequacy reform. Two months after the Lehman collapse, the 20 nations called for international standard setters to "set out strengthened capital requirements for banks' structured credit and securitization activities".⁹⁵ This prompted the Basel Committee, which had failed to make a single change to Basel II since the crisis broke out, to approve a set of enhancements to the Basel II trading book framework in July 2009.⁹⁶ At the Pittsburgh Summit in September 2009, the G-20 moved beyond the trading book, extending its demands to the whole of the Basel II framework. Setting a deadline of end-2010, the group ordered the Committee to formulate a new set of capital rules that would form the centerpiece of an 'international framework for reform'.⁹⁷ These rules would include, amongst other things, an international leverage ratio, more restrictive definitions of capital, countercyclical capital buffers, and surcharges for 'systemically important' institutions. In December 2009, the Committee took the first steps towards realizing the G-20's vision for a new capital regime, issuing a set of preliminary proposals whose details would be filled in over subsequent rounds of negotiations during 2010.⁹⁸ In a telling sign of the industry's frustration, IIF Managing Director Charles Dallara protested that "political forces are driving the reform agenda, and central bankers have been

⁹⁴ Data from IMF World Economic Outlook Database. Available at <<http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/index.aspx>>. Accessed 22/04/2010.

⁹⁵ G-20 2008, 2.

⁹⁶ BCBS 2009a.

⁹⁷ Available at <<http://www.pittsburghsummit.gov/media-center/129639.htm>>. Accessed 03/04/2010.

⁹⁸ BCBS 2009b.

marginalized in their role”.⁹⁹ Chairman Joseph Ackermann, meanwhile, complained that he was not “properly consulted” before the Pittsburgh Summit, and called on his fellow bankers to “start again with an intensive dialogue between the private sector and the public sector on the strategic questions, on the technical details, including what is the economic price of certain things we are doing”.¹⁰⁰

Why ‘Basel III’ will fail

Fortunately for banks, the December reform package is only the beginning of the story for ‘Basel III’. As public demand for change weakens with the resumption of growth in advanced economies and rule-making returns to the Basel Committee, there is now a major risk that the latest international capital accord will once more fall short of its creators’ aims. The technical specifications of the new accord will be worked out not in the high-profile working groups of the G-20, but in exclusive subcommittees lacking proper standards of due process and, most importantly, requiring no ratification by domestic stakeholders before taking force. According to my analysis, under these conditions timing and sequencing will *regain* their significance in the decision-making process, conferring a decisive advantage on those best informed about the regulatory agenda. As we will shortly see, this advantage once again belongs to large financial institutions. These institutions have exploited their first-mover status to water down the latest proposals using two principal tactics: conveying their views to regulators through private meetings; and spreading internal estimates of the costs of reform for consumers and the wider economy. They have also deployed a variety of delaying and circumventing tactics, which, although not

contingent on early involvement in the regulatory process, may nevertheless disrupt the swift and comprehensive adoption of ‘Basel III’.

The first and most successful of the industry’s strategies, using private meetings with regulators to effectively convey its views about the proposed reforms, has relied heavily on the personal links between large financial institutions and the regulatory community. One of the most prominent members of the current Basel Committee, the New York Federal Reserve’s Marc Saidenberg, was a head of regulatory policy at Merrill Lynch and a member of the IIF Committee on Market Best Practices until 2008. As recently as October 2007, the same month Merrill Lynch announced a record USD7.9bn loss on subprime-related investments, Saidenberg was busy lobbying regulators to “avoid a knee-jerk reaction to recent events”.¹⁰¹ Senior figures in the Basel Committee, meanwhile, have moved in the opposite direction. Darryll Hendricks, a Vice President of banking supervision at the Federal Reserve Bank of New York, now chairs the IIF Working Group on Valuation; Patricia Jackson, a former head of the Bank of England’s Industry and Regulation Division, chairs the IIF Working Group on Ratings; Roger Ferguson, a former Vice Chairman of the Federal Reserve, now sits on the institute’s board of directors. In perhaps its greatest coup, the IIF managed to recruit Jacques de Larosière, author of the abovementioned Larosière Report and until last year chairman of the EU’s High Level Group on Financial Supervision, to head its newly formed Market Monitoring Group (MMG). Despite acknowledging in the report that the crisis “has shown that there should be more capital, and more high quality capital, in the banking system, over and above the present regulatory minimum levels”, de Larosière has in recent months enthusiastically taken up the

⁹⁹ Available at < http://www.asiatoday.com.au/feature_reports.php?id=414 > . Accessed 04/04/2010.

¹⁰⁰ *Financial Times*, 03 October 2009.

¹⁰¹ *Financial Times*, 21 October 2007.

IIF's cause.¹⁰² "Capital ratios," he declared in October 2009, "if they are not well conceived, could substantially harm our economies. I see a great danger here. Regulators must not start piling new ratios on the existing ones, adding further requirements (leverage ratios, special ratios on large systemically important institutions, anti-cyclical capital buffers) to the normal – and revamped – Basel II risk-based system... Together, their impact could be lethal."¹⁰³

In recent months, the industry has taken advantage of these links to organize a series of off-the-record discussions with regulators regarding the 'Basel III' proposals. No less than a week after the Pittsburgh Summit in September 2009, the IIF held its annual membership conference alongside that of the IMF and World Bank in Istanbul, the latter attended by several members of the Basel Committee. After private talks with the Deputy Governor of the Bank of England and the General Manager of the BIS at the IIF conference, 1,700 bankers converged on the adjacent meetings to warn officials of what Ackermann called the "very real risk" that "regulatory reforms come into force that could undermine global recovery and job creation".¹⁰⁴ Supervisors were described as "furious" at the institute's attempt to derail the latest reform efforts. Even FDIC Chairman Sheila Bair, a featured speaker at the IIF conference, admitted to being "angry" at the industry's strategy: "They are working furiously against [reform]. Fear is their tactic. They say reform would stifle innovation. They say reform would impede the ability of our country to grow and compete in the global economy. But these are the very same arguments used to justify deregulation in the first place. Some want to keep the status quo. And, by implication,

they want to keep the taxpayer on the hook."¹⁰⁵ By early January 2010, however, confidential discussions with supervisors were beginning to yield more success for the industry. As leading politicians, supervisors and bankers gathered in Davos, Switzerland, for annual meeting of the World Economic Forum (WEF) – this year entitled 'Shaping the Post-Crisis World' and co-chaired by Josef Ackermann – officials started to express concerns about the pace of regulatory change. Giulio Tremonti, Italian Minister of Economy and Finance, went as far as to call the Committee's latest proposals as "the direct way to produce, if they are applied, a credit crunch".¹⁰⁶ These comments came only days after Tremonti participated in a WEF discussion group chaired by Ackermann on 'The Economic Governance of Europe' – a group that also included Jean-Claude Trichet, the President of the ECB, and José Manuel Barroso, President of the European Commission.

The second major tactic employed by the banking industry to combat the latest proposals is the public dissemination of internal estimates of the likely costs of capital adequacy reform to banks and the wider economy – despite the fact that the Basel Committee has yet to put any numbers to its proposals. A JP Morgan study published in February 2010 predicted that large banks would see their profitability fall by nearly two-thirds if the proposed reforms were implemented. To maintain their high returns on equity, banks would have no choice but to pass on the costs to consumers: "In order to return to similar levels of profitability as per current forecasts, we estimate that the pricing on all products would have to go up by 33%."¹⁰⁷ A second study, published by Morgan Stanley and Oliver Wyman in March, suggested that investment banks would see

¹⁰² De Larosière et al 2009, 16.

¹⁰³ *Financial Times*, 15 October 2009.

¹⁰⁴ *Reuters*, 04 October 2009.

¹⁰⁵ *Global Risk Regulator*, November 2009, vol. 7: issue 10.

¹⁰⁶ *Global Risk Regulator*, March 2010, vol. 8: issue 3.

¹⁰⁷ JP Morgan Chase 2010, 1.

their return on equity halve if the proposed reforms came into force: “A draconian regulatory outcome would require dramatic industry shrinkage and would require margins to rise 50-150% from today’s levels to have any hope of rebuilding returns north of 11%.”¹⁰⁸ With the consultation period nearing its end, these estimates have become even more extreme. In late April 2010, Project Oak, a working group made up of six major British banks, calculated that implementing the proposed reforms would cost the British economy GBP300bn, cutting GDP by 21% and eliminating up to 930,000 across the country – figures that, in the words of one central bank official, were “based on pure guesswork”.¹⁰⁹ In the same month, BNP Paribas, the largest French bank, went as far as to claim that ‘Basel III’ would cost European banks alone USD540bn in extra capital and USD2,000bn in new debt to finance lending. According to the bank’s chief operating officer: “The impact could reach six points of growth. If Europe accepts this, it means either two guaranteed years of deep recession or four years of zero growth.”¹¹⁰

In addition to these two strategies, the industry has used a number of delaying and circumventing tactics – many of which have been successfully applied to Basel II – to disrupt plans for the introduction of the new accord in 2012. Citing concerns about the global economic recovery, senior bankers such as HSBC Chairman Stephen Green called for new rules to be “gradually phased in over several years”, while bodies like the British Bankers’ Association have openly admitted to lobbying for concessions on “timing, transition and grand-

fathering”.¹¹¹ In recognition of these concerns, the Basel Committee promised in its December package that “appropriate grandfathering and transitional arrangements will be established which will ensure that [implementation] is completed without aggravating near term stress”.¹¹² As one analyst from Japanese investment bank Nomura remarked, the package is “very stringent in the first reading but the caveats on timeline and grandfathering mean that the final proposals are likely to be watered down”.¹¹³ Other banks, though, are not waiting for the Committee to loosen its stance. According to the *Financial Times*, as of April 2010 institutions such as Goldman Sachs, JP Morgan and Deutsche Bank were developing products to help them circumvent proposed restrictions on the components of core capital.¹¹⁴ In particular, banks have focused on methods of converting deferred tax assets – ineligible as capital under the latest rules – into an equivalent instrument which the Committee deems legitimate for capital purposes. Praised as ‘good creative thinking’ by the industry, these practices are widely seen, as one reporter put it, “as the latest evidence that banks have not learned their lesson from the crisis and will always focus on arbitraging the system for a profit, however tough the rules”.¹¹⁵

Leverage ratio, systemic surcharge and countercyclical capital buffers

How effective have these strategies been in diluting the latest proposals? Recent developments suggest that large international banks are already enjoying considerable success in

¹⁰⁸ Available at <<http://www.efinancialnews.com/story/16-03-2010/oliver-wyman-morgan-stanley-regulation>> . Accessed 04/04/2010.

¹⁰⁹ Author’s interview with regulatory official, London, February 2010.

¹¹⁰ *Financial Times*, 11 April 2010.

¹¹¹ *Global Risk Regulator*, March 2010, vol. 8: issue 3. ‘Grandfathering’ involves allowing an outdated rule to continue to apply (under certain circumstances) despite the introduction of a new rule.

¹¹² BCBC 2009b, 13.

¹¹³ *Financial Times*, 18 December 2009.

¹¹⁴ *Financial Times* 12 April 2010.

¹¹⁵ *Ibid.*

weakening 'Basel III', with key elements appearing increasingly likely to be relaxed or even dropped from the final version of the accord in the face of industry pressure. Banks represented on the IIF Steering Committee on Regulatory Capital, including Société Générale and UBS, have privately informed investors that crucial parts of the package "just won't go through", while José Manuel Barroso told leaders at an EU summit in March that there were "worrying signals" that the latest rules on capital adequacy were being "watered down".¹¹⁶ Even members of the Basel Committee have conceded that substantial modifications to the consultative document are likely. One revealed that: "While it's clear that some kind of reform will happen, it's also clear that what's adopted will be a heavily watered down version of what appears now. It's inevitable."¹¹⁷ Three parts of the reform package look particularly susceptible to industry pressure: the international leverage ratio; the capital surcharge for systemically important institutions; and countercyclical capital buffers. As I show in the rest of the section, large international banks have succeeded in shifting the regulatory consensus against these measures, ensuring that, if not already abandoned by the end of the consultation period, they are significantly weakened and rendered non-binding in the final version of the accord.

Perhaps the most vulnerable of these three proposals is the leverage ratio, a simple ratio of equity to total (non-risk-weighted) assets introduced to provide a backstop against "model risk and measurement error".¹¹⁸ With some

version of the ratio already in place in Canada, Switzerland and the United States, the Basel Committee's proposal to extend a leverage cap to all G-20 countries has met with fierce resistance from European banks. One week after the publication of the December reform package, Denmark's largest financial institution, Danske Bank, protested that a leverage ratio would fail to capture the low risk inherent in its large mortgage portfolio, while Sweden's SEB argued that a non-risk-based ratio "does not really make sense".¹¹⁹ The Association of German Banks (BRB) went even further, calling for the measure to be scrapped on the grounds that it "won't help to stabilize the financial system", but rather "would force banks to scale back their lending and therefore slow down the economic recovery".¹²⁰ Surprisingly, counterbalancing efforts by large American, Canadian, or Swiss banks to 'level the playing field' have failed to materialize, eliminating a valuable source of private 'entrepreneurs' in support of regulatory change. This is largely a consequence of the perceived stringency of the Committee's proposal, which, unlike existing ratios, would capture all off-balance sheet assets and would not permit the netting of derivatives exposures.¹²¹ With even banks such as JP Morgan and UBS highlighting its "dramatic undesirable effects", the chances of an effective leverage provision emerging from the consultation period are small.¹²² Describing the lobbying by banks as "indirect but intense", the Chairman of the Netherlands Authority for Financial Markets (NFA), Hans Hoogervorst,

¹¹⁶ Available at <<http://www.bloomberg.com/apps/news?id=20601208&sid=a6Xz3VltlOGw>>. Accessed 04/04/2010; available at <<http://www.europeanvoice.com/article/2010/03/reform-of-financial-services-supervision-being-watered-down-/67544.aspx>>. Accessed 04/04/2010.

¹¹⁷ Author's interview with BCBS member, London., February 2010.

¹¹⁸ BCBS 2009b, 7.

¹¹⁹ *Reuters*, 22 December 2009.

¹²⁰ Available at <http://www.german-banks.com/html/15_press/press_00_100305.asp>. Accessed 04/04/2010.

¹²¹ In the words of one credit analyst at Moody's, the proposal is 'far more draconian than the version currently being used in the U.S. and Switzerland'. *Global Risk Regulator*, February 2010, vol. 8: issue 2.

¹²² Available at <<http://www.bis.org/publ/bcbs165/jpmorganchase.pdf>>. Accessed 04/04/2010.

admitted in March 2010 that there was a “considerable risk” that future leverage ratio requirements would be both too low and non-binding in the final version of the rules.¹²³ Indeed, in its December proposals, the Committee refused to commit to placing the ratio in Pillar 1 of the capital framework, proposing that it instead form part of Pillar 2 – leaving its implementation at the discretion of national supervisors. It is no coincidence that just three months before, as news of the G-20’s latest plans emerged, IIF Managing Director Charles Dallara had specifically called for “leverage [to] be considered in this context under the so-called ‘pillar two’ of the Basel II accord”.¹²⁴

The proposed capital surcharge on systemically important banks has run into similar problems. After failing to influence the G-20 with a lengthy report in July 2009 deeming it “absolutely counterproductive”, the IIF in recent months has intensified its lobbying efforts against the proposal, warning regulators as early as September 2009 of the dangers of “setting up artificial categories of systemic firms”.¹²⁵ The banking industry, however, has not been united in its opposition to the surcharge. Smaller financial institutions, seeking to neutralize the capital advantage enjoyed by large banks under Basel II’s A-IRB approach, have strongly supported the surcharge. Blaming the financial crisis on “the reckless lending of a handful of a few large U.S. banks”, the ICBA has argued that the “largest financial institutions in the United States that are now considered ‘too big to fail’ should be subject to a more rigorous set of leverage and risk-based capital requirements than other institutions and that are not determined by the institutions themselves based on

internal risk-ratings formulas”.¹²⁶ The World Council of Credit Unions (WOCCU), a trade association representing 54,000 not-for-profit credit unions around the world, has expressed similar views: “...the global financial crisis exposed the fact that large complex financial institutions are interdependent to a much greater degree than smaller community-based financial institutions. We have advocated with the Basel Committee since 2003 that this situation demands higher, not lower, capital requirements for large financial institutions, as the current calibration of Basel II suggests.”¹²⁷ Once again, however, these institutions may have arrived too late to secure their favored outcomes. By the time community banks registered their support for a capital surcharge – the end of the comment period on December’s consultative document in April 2010 – the Committee had already reached its own conclusions about the proposal. As early as March 2010 one member noted a “deeply-held skepticism around the table” regarding a rule-based capital add-on.¹²⁸ By mid-April, one week before the end of the comment period, the Committee subgroup charged with overseeing the proposal had already begun developing approaches for incorporating the surcharge into Pillar 2 of the new framework.¹²⁹ According to one member of the subgroup, “The capital surcharge will almost certainly be in Pillar 2 – if it even makes it into the final accord. Most members [of the subgroup] either want it in Pillar 2, because

¹²³ Available at <<http://www.businessspectator.com.au/bs.nsf/Article/Regulator-warns-against-caving-in-on-bank-reform-357VQ?OpenDocument>>. Accessed 04/04/2010.

¹²⁴ *Financial Times*, 14 September 2009.

¹²⁵ IIF 2009; *Financial Times*, 14 September 2009.

¹²⁶ Available at <<http://www.bis.org/publ/bcbs165/icboa.pdf>>. Accessed 04/04/2010.

¹²⁷ Available at <<http://www.bis.org/publ/bcbs165/wcocuc.pdf>>. Accessed 04/04/2010.

¹²⁸ Author’s interview with BCBS member, London., February 2010.

¹²⁹ *Ibid.*

they think it will have no bite there, or they don't want it at all."¹³⁰

Finally, the Committee's attempt to mitigate the pro-cyclicality of the existing capital framework is likely to face more mixed fortunes. The proposed adoption of 'forward-looking provisioning' – an accounting practice that entails setting aside reserves for *expected* losses rather than actual losses – has been strongly supported by the Spanish banking industry, which has been subject to a similar requirement since July 2000. Banco Santander, Europe's largest bank and member of the IIF Steering Group on Regulatory Capital, has backed the proposal from an early stage, reiterating in its April 2010 comments to the Committee that "having experienced the positive, anti-cyclical effects of forward-looking provisioning during the crisis, Santander is in favour of introducing them integrally in the banking community".¹³¹ Consequently, despite opposition from HSBC, UBS and the American Bankers Association, forward-looking provisioning is likely to feature in the final version of 'Basel III', with one member of the Committee describing the proposal as being "warmly embraced" at a Committee plenary in March 2010. Other measures to tackle pro-cyclicality, however, look considerably less likely to survive the consultation process. The Committee's proposal to introduce 'countercyclical capital buffers' – buffers which are raised above regulatory minima in economic upswings and subsequently drawn upon as losses are incurred during periods of stress – has been contested by almost all segments of the industry. Several banks have followed the IIF's lead in arguing that, because of the 'limitations of any single variable' tracking the economic cycle, the implementation of countercyclical buffers should be non-binding

¹³⁰ Author's interview with regulatory official, London, February 2010.

¹³¹ Available at < <http://www.bis.org/publ/bcbs165/santandercapita.pdf>>. Accessed 04/04/2010.

and placed in Pillar 2 of the new framework.¹³² Even before the release of the latest proposals, there were signs that regulators were beginning to accept this view. On the eve of its final meeting in December 2009, the Committee was reportedly divided between members who favored linking the capital buffer to a standard macroeconomic indicator (such as a credit-to-GDP ratio) and members who remained 'skeptical' of any attempt to measure credit growth, with one likening it to "a search for the Holy Grail".¹³³ At its March 2010 plenary, the Committee was said to have given a "lukewarm reception" to preliminary proposals developed by the Macro Variables Task Force (MVTf), the Basel subgroup charged with overseeing the workstream.¹³⁴ The MVTf Chairman, the Bank of Canada's Mark Zelmer, later told his counterparts that a binding version of the proposals at best stood a "roughly even" chance of being adopted in 'Basel III'.¹³⁵

To summarize, the neo-proceduralist analysis outlined in section IV offers a pessimistic assessment of the prospects of 'Basel III'. As the first to contribute to the post-crisis regulatory discourse, large international banks have managed to regain control of the Basel process, with potentially devastating consequences for the latest efforts to create an effective international capital regime. The initial success enjoyed by these groups, as our theory predicts, has derived both from their privileged access to information about the Basel process, mainly through close contacts within the regulatory community, and the exclusive setting in which the latest proposals have been debated. With these conditions in place, only one outcome remains likely. Just as the Basel Committee of

¹³² Available at < <http://www.bis.org/publ/bcbs165/ioif.pdf>>. Accessed 04/04/2010.

¹³³ *Risk*, 11 December 2009.

¹³⁴ Author's interview with regulatory official 2, London, February 2010.

¹³⁵ *Ibid.*

the late 1990s failed to meet its objectives for a new capital accord, the Basel Committee of the late 2000s – ten years and one global financial crisis later – may be about to meet a similar fate.

VI. CONCLUSION

When the Basel Committee decided to update the original Basel accord in 1998, it had high hopes for a new international standard for capital regulation. The new accord, the Committee claimed, would remedy the defects of the existing regulatory framework and significantly improve the safety and soundness of the international banking system. Why did Basel II fail to live up to these expectations?

Basel II's failure, in a nutshell, was the result of regulatory capture. A small group of international banks were able to take control of the Basel process, transforming the rules of international capital regulation to maximize their profits at the expense of those without a seat at the decision-making table. According to the neo-proceduralist analysis I have presented, capture had its origins in the interaction of demand- and supply-side factors in the negotiation stages of the regulatory process. Large asymmetries in information on the demand side, exacerbated by a closed and club-like regulatory forum on the supply side, gave large international banks crucial first-mover advantage in negotiations, allowing them to shape decisions in a way that was difficult to reverse at later stages. Latecomers had little choice but to accept what was in effect a *fait accompli*.

Unfortunately, as we have seen, these very same factors may have also jeopardized the latest attempt to reform international capital requirements, 'Basel III'. Given the importance of reform in this area for the health of the global economy, it is crucial therefore that we heed the lessons of the neo-proceduralist anal-

ysis. Future efforts to revise capital adequacy standards must both observe basic standards of due process and ensure that information asymmetries are as small as possible – principally, but not exclusively, by maintaining some kind of distance between supervisory bodies and the banking industry. Though difficult in practice to achieve, if implemented faithfully, these changes would go a long way towards ensuring that the next time regulators set out to revise international capital standards, they achieve every one of their aims.

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