THE BASEL CAPITAL ADEQUACY ACCORDS AND
THE GOVERNANCE OF GLOBAL FINANCE

BY

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Abstract of the Dissertation

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By Daniel L. Herman

Dissertation Director: Yale H. Ferguson

What is the net contribution of the Basel Accords to the governance of global finance?
The methodology used in this dissertation for assessing the costs and benefits of the Basel Process is the comparison of intended consequences and unintended consequences. Intended consequences are in the public interest and regarded as benefits. The unintended consequences are the side effects of those regulations which, it is assumed, no regulator would have deliberately selected or favored. They are the costs of the Basel Process. The major unintended consequence discussed in this dissertation is the accumulation of over-leveraged and undercapitalized financial risks outside the banking supervisory framework of the Basel Accords. The conclusion of this dissertation is that while the Accords have contributed to the stability of the international banking system, they have also given market participants the incentive to evade regulations and create financial risks in the “shadow banking system.” The Basel Accords, in short, indirectly contributed to the Panic of 2008 and the Global Financial Crisis. Therefore, the costs of the Basel Process have outweighed its benefits.
Acknowledgements and Dedication

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I would like to dedicate this dissertation to Dr. Yale Ferguson who inspired and encouraged me in my undergraduate years and later invited me to join the fledgling Center for Global Change and Governance (now known as the Rutgers Division of Global Affairs). The continued growth and vitality of the DGA is an enduring tribute to his work.
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Chapter 1: Overview of the Dissertation

This dissertation will attempt to answer the question: have the costs of the Basel Capital Adequacy Accords outweighed the benefits?\textsuperscript{1} The central focus is the interplay between the concepts of global financial stability and economic competitiveness, and the role of the Basel Accords in the harmonization of global capital adequacy standards in the banking industry.

Regulating capital adequacy is a blunt instrument. Like the regulation of interest rates or exchange rates, regulating capital inherently benefits some banks and harms the competitiveness of other banks. The issues here are large versus small banks, investment banks, banks dealing with small enterprises, home mortgages, consumers versus corporations, and so on.\textsuperscript{2} However “harmonizing” international capital regulations is not an obscure academic proposition: regulating the level of capital in the banking system is like regulating the level of economic activity in an individual economy and ultimately in the global economy. In the aftermath of the Global Financial Crisis (GFC), we now know that regulating the capital adequacy of banks alone is not sufficient to insure stability and competitiveness.

The Basel Accords were an essential building block for achieving global financial stability once the Bretton Woods system was abandoned and international capital flows became increasingly unregulated.\textsuperscript{3} The Accords have contributed to the stability of the international banking system but, in the process, have given market participants the incentive to evade regulations and create financial risks in new markets.
Almost every aspect of the matters discussed in this dissertation is contentious. How should the riskiness of bank investments be measured? What is the distinction between “Tier 1” and “Tier 2” capital? How can a global regulatory standard be crafted which does not confer competitive advantages on certain types of banks? Does the profusion of loopholes dilute the effectiveness of the agreement? Should bank capital levels be adjusted during recessions and expansionary phases of the business cycle?

The “Basel Process” is often used to refer to the role of the Bank for International Settlements in the governance of the global financial system and to the coordination efforts needed to achieve global financial stability shared between finance ministries, central banks, and regulators. The term “Basel process” is used in this dissertation to refer to the policymaking process for the regulation of capital in the financial system (not only banks) and the stability of the global financial system. The Basel Accords themselves are a number of documents that are continually under revision. Parties articulate, negotiate, and reconcile their perceived interests and implement agreements, which are then reevaluated in a continually iterative process.

The first agreements, Core Principles, established the principle of Home Country (rather than Host Country) control over international banking and a global set of “best practices”. The second set of documents, on which this dissertation concentrates, concerns the harmonization of national standards for maintaining adequate capital in the banking system.

The timing of implementation is a large part of the challenge for global governance. Since there are no treaties to be debated and ratified, the Basel Process is based on the
implementation of global regulations once the national regulators have approved them. In fact, there were no grand negotiations to involve all or even most affected nations. There have been numerous exceptions made by which national regulators are given the “discretion” to apply the regulations or even to ignore them.

1.1. Hercules, Sisyphus and the Governance of Global Finance

“Getting the Basel II agreement involved a torturous process of international negotiations amid massive lobbying by different groups of bankers.”5

‘I hope that you can in fact bring the Basel process to a conclusion and I never have to think of it again for about six years,’ Rep. Barney Frank told the Fed chief…‘My basic concern is that I have to pay attention to it and it gives me a headache. It's Rubik's Cube -- every time you do one thing, six other people get upset.’ 6

The goals set by the Basel Committee on Banking Supervision (BCBS) were the result of a Herculean effort to devise a comprehensive set of standards, to implement those standards without the use of international treaties or law, and to do so with any enforcement power of their own. One might think that the relationship between competitiveness and regulation is straightforward since it is clearly in the interest of countries to foster competitiveness while protecting the stability of the financial system. A proper system unshackles entrepreneurs from bureaucratic oversight and allows them to deliver their product to the broadest markets at the least cost.
Basel I has been applied in more than 120 countries and thus has progressively assumed
the role of a global standard. Basel II is much more complex and problems posed by its
implementation have been a major focus of attention for many years.\textsuperscript{7}

Basel I represented the first attempt to govern financial globalization and to regulate “the
infrastructure of the infrastructure” of world order.\textsuperscript{8} The Basel Process has had two main
dimensions. The first (and earliest focus of the Basel Committee) was the promulgation
of a set of “best practices” in banking, including assignment of responsibility to the home
country rather than the host country.\textsuperscript{9}

The Basel Accord of 1988 was a significant milestone in the governance of the global
financial system: defining regulatory capital, measuring risk-weighted assets, and setting
minimum acceptable levels for regulatory capital. Basel I incorporated a risk-weighted
approach and a two-tier capital structure. The latter means that there was base primary
capital (stocks, retained earnings, general reserves, and some other items) and a second
tier of limited primary capital including some types of subordinated debt. The second tier
capital could not exceed half of total base capital in counting towards the capital
adequacy ratio.\textsuperscript{10}

Basel I was as much a response to the fragility of the international banking system as a
reaction of US banks to the dramatic growth of the Japanese presence in the international
banking market.\textsuperscript{11} Woods notes that while the regulatory authorities sought to contribute
to international financial stability, the regulated banks sought to gain (or protect) their
competitive advantages in the marketplace for financial services.\textsuperscript{12} Although U.S.
congressional hearings on Basel I began with a focus on the threat to financial stability,
the focus soon shifted almost entirely to their demand to confront the Japanese banks by “leveling the playing field”.\textsuperscript{13}

In the mid 1990’s, pressures grew from the largest international banks to revise the first Basel agreement. Basel II attempted to achieve seemingly irreconcilable goals: increase the risk-sensitivity of capital requirements without exacerbating the pro-cyclicality of lending; increase the safety and soundness of the banking system without changing the overall level of capital in the banking system; and provide capital reduction incentives for the adoption of more sophisticated techniques. Consensus remained that all of these goals should be pursued but only while maintaining a “level playing field”.\textsuperscript{14}

The Basel Accords were initiated through bilateral negotiations between the US and Britain in the early 1980’s. Those negotiations were expanded to the G10 nations and led to the first Basel Accord in 1988. The agreement created an international standard for banking regulation that has been voluntarily adopted by approximately 120 nations.

The negotiation and implementation of those standards appears to be a Sisyphean effort. The Basel Committee has been working on the harmonization of global regulatory capital standards since the early 1980’s. The standards have been continually revised to cope with new challenges from financial instruments and financial risk management techniques.\textsuperscript{15} Strulik summarizes the dynamic between the regulators and the regulated: “the banks have answered the regulatory demands for improvements in equity… with an increase in non-balance sheet business (in particular innovations in derivatives) which does not have an effect on the supervisor’s equity demands.”\textsuperscript{16}
This Sisyphean effort has institutionalized an “iterative” process in the governance of global finance. The Committee announces proposals; the financial industry is invited to evaluate those proposals; programs are undertaken to determine the impact of the new proposals (Quantitative Impact Statements); the proposals are revised again, critiqued, and retested. Meanwhile a number of countries may choose to implement some of those proposals while others still debate them. The resulting process is disjointed, inadequately implemented and, since the Basel Committee lacks enforcement, can be circumvented by the adoption of the use of supervisory “forbearance” based on the unique conditions of each banking system.\(^{17}\)

When economic growth is strong and sustained, the role of business in the governance of global finance generally goes unchallenged. It is only after a financial catastrophe that regulatory endeavors such as the Basel Accords come into open question. In the popular literature, the regulation of banking capital is equated with regulatory capture.\(^{18}\) Quite likely, the Basel Process would have remained a topic of little general interest were it not for the recent Global Financial Crisis. However, most of the writers on the subject only mention the role of Basel in passing.\(^{19}\)

Post-crisis analysis has revealed that the adequacy of capital (and the “adequacy of liquidity” or access to readily available cash) were keys to global financial stability. Without adequate capital, the credit-creating function of the global financial system “froze up” resulting in tremendous global economic damage.

The Basel Process provides ample illustrations of Robert Putnam’s observation that multilateral diplomacy is a multilevel bargaining process.\(^{20}\) While negotiations occur at
the international level, negotiations are occurring within each participating state, between regulators and the industry, regulators and the legislature, within the financial industry, among domestic negotiators, between domestic and foreign negotiators, as well as among academic policy experts, think tanks, and the financial press.21

To appreciate its true complexity, the Basel Process can be broken down into types of banks, financial regulators, lobbyists, and so on. The United States, for example, is characterized as having a “dual banking system” divided between the “money center” banks and the “community” banks. This sets American national regulators (the Federal Reserve, FDIC, Controller of The Currency, Office of Thrift Supervision and state bank supervisors) at odds with each other because of the financial constituencies they represent.
### 1.2. Disciplinary Perspectives: A Literature Matrix on the Basel Process

The following chart shows the extensiveness of the literature on Basel Process and its relevance to this dissertation.

<table>
<thead>
<tr>
<th>AUDIENCE / SUBJECT MATTER</th>
<th>TOPICS OF INTEREST</th>
<th>RELEVANCE TO DISSERTATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Regulators, Bank supervisors, central bankers, auditors, compliance officers</td>
<td>Detailed banking business practices</td>
<td>Need to understand concepts and concerns (at a high level)</td>
</tr>
<tr>
<td>Quantitative analysts: credit analysts, financial risk</td>
<td>Algorithms, validation of models, results of quantitative impact</td>
<td>Out of scope</td>
</tr>
<tr>
<td>Bankers and traders</td>
<td>Implications of regulations</td>
<td>A key piece in the puzzle</td>
</tr>
<tr>
<td>Lawyers: Banking Law</td>
<td>Interaction of Basel “soft law” with national and international law</td>
<td>Conflicts in national regulations and statutes</td>
</tr>
<tr>
<td>Market analysts</td>
<td>Competitive impact of regulations</td>
<td>Out of scope</td>
</tr>
<tr>
<td>Financial journalists</td>
<td>Current developments</td>
<td>Essential “raw data”</td>
</tr>
<tr>
<td>Financial historians</td>
<td>Historical developments</td>
<td>Essential “raw data”</td>
</tr>
<tr>
<td>Economists</td>
<td>Economic impact of Basel rules</td>
<td>Vital questions and answers</td>
</tr>
<tr>
<td>Political Scientists</td>
<td>International political economy and global politics of the Basel Process</td>
<td>In scope</td>
</tr>
</tbody>
</table>
Certain aspects of the Accords lend themselves to quantitative analysis. Has the increase in regulatory capital led to a slowdown in economic growth in advanced industrial nations or in emerging markets? Has the increase in regulatory capital enhanced competitive advantage of one state over another or one type of bank over another? Has it benefited nations that rely on capital markets (rather than banks) for working capital? How effective will new regulations be if they do not deal with the underlying incentives to take reckless (but potentially lucrative) speculative positions?

Continuing with the perspectives on the Basel Process, one can take the professional perspective of a bank regulator or examiner, a risk analyst, a financial industry analyst or lobbyist, a lawyer, or an information systems architect. Credit analysts and risk modelers are concerned with techniques of credit and market risk analysis. Market analysts look at the Basel Process and its impact of market shares (since the regulation of bank capital fundamentally affects the profitability and competitiveness of banks internationally).

Bank supervisors and compliance auditors are professionally interested in the technical definition of regulatory capital. The mathematically oriented will focus on the application of modern risk management techniques in designing the Basel Accords. To the financially oriented, Basel involves statistical concepts such as probability of default (PD), loss given default (LGD) and exposure at default (EAD). To the business oriented, it involves studies of the market impact of changes in bank capital structures and costs of doing business. To computer scientists, it involves massive projects on a scale similar to Y2K to analyze and communicate complex capital calculations between the large banks and the regulators.
To those interested in banking law, it involves the interaction of international “soft law” and national laws in multiple national regulatory environments and the interaction of those “laws” with laws enacted domestically and internationally, given that some countries intend to implement Basel II more broadly or sooner than others.26

1.3. In and Out of Scope

“Most Global Governance actors operate with little publicity and far off the radar except for those relatively few states and citizens most closely affected by their activities.” 27

This dissertation incorporates insights from all of the above perspectives. However, it is not intended for an audience of banking supervisors, central bankers, credit analysts, auditors, risk modelers, economists, or legal scholars. It is based primarily on the literature of International Political Economy and Global Governance.28 The main concern of that literature is the interaction of political and economic forces shaping the regulations and standards that govern the global banking industry.

The Basel Process is often criticized as favoring those with specialist knowledge and private interests rather than the wider public interests in financial stability and economic development. It is a “black box” subject in the sense that all of the actual negotiations of the Basel Committee are conducted behind closed doors without records of discussions, debates, and votes. A further obstacle to assessing the effect of Basel Capital Adequacy regulations is the fact that the information on bank supervisory effectiveness and enforcement is confidential information.29 Reporting by financial journalists and the few examples of “insider reporting” in the scholarly literature will be utilized extensively in this dissertation. Since this author does not possess “inside information” about the Basel
Process, insiders and journalists have been relied on. There is very limited scholarly literature in political science on the Basel Process.\textsuperscript{30}

Daniel Tarullo has provided the most useful scholarly account of the Basel Process (specifically of Basel II). Appointed by President Barack Obama in January 2009 to a 14-year term on the Board of Governors of the Federal Reserve, Tarullo’s book on Basel II (\textit{Banking On Basel: The Future of International Financial Regulation}) has been of great help in conducting this dissertation.

\section*{1.4. The Chapters Ahead}

\textbf{Chapter 2} will present the research question: what is the net contribution of the Basel Process to the governance of global finance? The cost-benefit methodology will be discussed. The concepts of Regulatory Capture and Public Choice will be utilized to justify the classification of Intended Consequences as benefits and of Unintended Consequences as costs of the Basel Process. The major Unintended Consequence discussed is the incentive created by Basel I to solve “the Basel problem” by removing investments from the balance sheets of banks. This practice, known as “regulatory capital arbitrage,” is not to be confused with “regulatory arbitrage” (shopping for the most lenient regulator whenever possible).\textsuperscript{31} The “net contribution” to the governance of global finance” is simply defined as the benefits minus the costs of the Basel Process.

As discussed above in “Disciplinary Perspectives: A Literature Matrix on the Basel Process”, there are many ways to approach the study of the Basel Process. Chapter 3 will locate this study of the Basel Process in the literature of Global Governance. The chapter will describe the most useful concepts and paradigms--ways of looking at the subject--in
the literature. Controversies in the literature, as well as suggestions for controversies missing from the literature, will be described. They have been divided into the following categories:

- Universal Controversies
- Controversies resulting from structural differences between national financial systems
- Controversies emerging from innovations in financial markets, products and risk management techniques
- Controversies inherent in the international negotiating process
- Controversies inherent in the national negotiating process
- Controversies inherent in the implementation and enforcement phases of global agreements
- Controversies inherent in applying “lessons learned”
- Controversies over the best method for the assessment of major global governance projects

These controversies will be explored in the future chapters.

The next three chapters are organized around the “5W-H” format (who, what, when, where and how). Chapter 4 deals with the participants in the Basel Process representing close to 120 nations, their individual governmental and non-governmental units, and the transnational elements of banking supervisors, other financial regulators, and supranational entities including the Basel Committee, IMF, and World Bank.

A goal of this dissertation is to show that the popular view of the Basel Process is an oversimplification. One cannot speak of “the banks” as if they were a monolithic force in the Basel Process even in the United States. From a traditional International Relations perspective, the Basel Process can be analyzed in terms of types of countries, such as the
wealthy members of the OECD, the middle ranking states, and the emerging market economies. This brings shifting balances in the distribution of global power into focus. However, within each of the more than 120 governments involved, the Basel Process may be analyzed in terms of the executive branch versus the legislative and judicial branches. Central banks within each state may be independent but they too may favor certain constituencies. Thus, the conflicts between central banks, finance ministries, and other financial regulators in each state must be taken into account (to the extent that such dynamics are public knowledge).

Chapter 5 discusses the when, where and how questions under the heading of the “International Financial Diplomacy of The Basel Process.” Why have the discussions over the international harmonization of regulatory capital been in session for the past three decades? What have been the major milestones in those negotiations? Have any patterns emerged? How does the process of negotiating international soft law compare to the formal process of international treaty making?

Although the Basel Accords are an example of international soft law, the process of formal international negotiations will be utilized to describe the iterative nature of Basel. A brief historical synopsis will be presented including the outline of the Basel Process in its latest iteration known as “Basel III”.

In Chapter 6, some of the specific topics of negotiation will be discussed. The “structural differences” between countries participating in the negotiations (as well as the vast majority which are not party to the negotiations) will be highlighted. The subject is one of international political economy in that it affects competitive position within the financial
systems of individual countries and in the financial position between them. These issues will be organized around the three “pillars” of the Basel II Agreement: (Pillar 1) minimum capital requirements, (Pillar 2) the supervisory review of an institution's internal assessment process and capital adequacy; and (Pillar 3) the effective use of disclosure to strengthen market discipline as a complement to supervisory efforts.

Chapters 7 and 8 will offer an answer to the research question posed in Chapter 2, namely, given the costs and benefits, what is the net contribution of the Basel Process to the governance of global finance?

Since the subject of this dissertation (banking regulation, financial market instruments and practices) is not commonly studied in the global governance literature, a section has been added at the end entitled “Abbreviations, Terms and Concepts” which the reader should perhaps consult before reading further. Endnotes and Bibliography have been provided as well as numerous sources for online access to sources consulted. If any web addresses do not work correctly, the reader is advised to copy those web addresses from this document and open them in a separate browser window. All of the web addresses in this dissertation were validated as of publication date.
Chapter 2: What is the Net Contribution of the Basel Process to the Governance of Global Finance?

2.1. Cost-Benefit Methodology

The research question of this dissertation is “what is the net contribution of the Basel Accords to the governance of global finance?” A simple listing of costs and benefits will not help answer the question as one could list 100 costs and only 10 benefits. This does not answer the research question because each benefit may be “10 times more important” than each of the 100 costs. Thus the challenge of this dissertation is ultimately whether a method of weighting costs and benefits can be devised such that the value of each type of cost and benefit can be directly assessed, aggregated, and yield a reasonable answer to the research question.

In theory, it would be most efficient to assign a numerical value to the outputs of policy. Like the grading procedure in a classroom, we would add up the results and implicitly subtract points for what the student failed to accomplish. The net result would be a grade. This dissertation will not attempt to “grade” the Basel Accords numerically because that narrows the focus of what is being evaluated too drastically.

2.1.1. Regulatory Motivations and Outcomes

What criteria can we use for weighing the costs and benefits of the Basel Process? The literature on regulation distinguishes the motivations from the outcomes of regulators. It describes an ideal type of regulator, one who is dedicated to advancing the Public
Interest. This type of regulator, the “Burkean” type, is seen as so dedicated to advancing the Public Interest that he or she will make every effort to achieve those goals without any public discussion.\textsuperscript{33} Having devoted almost fifty years to central banking and financial regulation, former Fed Chairman Paul Volcker can be regarded as the quintessential embodiment of this type of regulator.\textsuperscript{34}

While the controversy between Public Choice and Regulatory Capture is central to understanding the methodology for weighing costs and benefits of the Basel Process, a fuller discussion \textit{will be deferred} until the second half of the following chapter in the section entitled “Public Choice versus Regulatory Capture Theory.”

Doubtless, it is offensive to professionals involved in the design or implementation of the Basel Process to discuss whether their work has been tainted by the influence of Regulatory Capture. This is even more so because the work on the Basel Accords failed to provide the global financial stability originally intended. Regulators might respond that that Basel I and II were not intended to provide global financial stability, were only applied to banks (not shadow banks) and had not been fully implemented when the GFC began. Participants in the Basel Process may prefer to avoid the limelight in defending the effectiveness of Basel II.

The set of policy goals pursued by the Burkean regulator is being equated with the Intended Consequences because they are, by definition, in the Public Interest. However, while regulators attempt to advance the Public Interest, there is normally a countervailing process at work to advance Private Interests.
The approach to identifying the costs and benefits of the Basel Process is to attribute “Burkean motivations” to regulators and assume that they have the Public Interest at heart; have the specialized knowledge required to understand the subject matter; and have devoted their professional careers to advancing the policy (in contradiction to the “revolving door” school of thought). The Intended Consequences of this ideal type of Burkean regulator, by definition, advance the Public Interest, unless they become victims of their own conflicts of interest or other forms of criminal behavior.

Basel II is implicated as a cause of the Global Financial Crisis in the recent scholarly literature because of its “unintended consequences”. The Unintended Consequences are the side effects of those regulations, which result in financial risks being accumulated outside the banking supervisory framework of the Basel Accords. In terms of the Basel Process, once a new proposal is issued through a “consultative paper,” an iterative process starts whereby the industry assesses those standards and the bargaining process begins. Once the industry evaluates and reacts, the chances that the regulators will achieve their intended goals are diminished by the pursuit of the economic goals of the regulated industry, which is by no means monolithic. Referring to the chart in Section 3.2.9.1, the tension between stability and competitiveness pulls the regulators from the Public / Public quadrant to the Public Officials / Private Goals quadrant (that is, from Quadrant 1 to 2). The positive Intended Consequences then become contaminated with the negative Unintended Consequences.
2.2. The Intellectual Puzzle: Stability versus Competitiveness

“...To grasp the scale of total assets in the global banking system, total bank assets are as great as the combined total of the stock-market capitalization of all the world’s exchanges added to total public-debt securities. This is more than twice the size of total global pension-fund assets, and more than 40% larger than world GDP. It follows that 8–10% of this total is a very big number indeed, which is what the Basel II capital-adequacy ratios demand banks retain as, basically, unusable capital in their capital reserves.35

A Rutgers instructor of mine suggested that an effective dissertation should have two concepts in mind that are encountered throughout the entire dissertation.36 These two concepts should be defined and then investigated as to whether A causes B or B causes A or what the relationship is between them (if any). The two concepts identified in this dissertation are global financial stability and economic competitiveness.

Referring to the chart below, Curve A (“managers’ preferences”) represents the goal of “economic competitiveness” as pursued by the financial industry. Curve B (“regulators’ preferences”) represents the goal of “global financial stability” as pursued by banking supervisors, central banks, and other financial regulators. As the Risk-Return frontier increases (greater risks requiring greater rewards), the preferences of “managers” and “regulators” follow different trajectories. This is the heart of the regulatory dilemma.
“Varying the degree of leverage creates a tradeoff for shareholders between risk of insolvency and rate of return. Bank regulators, who are concerned about the spillover effects that bank failures have on the rest of the economy, tend to prefer less risk, less leverage, and more capital than do bank managers. To limit risk to the financial system, regulators set minimum standards for bank capital.”

37
2.2.1. Global Financial Stability and the Capital Adequacy of the Banking System

Global financial stability is a non-excludable global public good that does not come without cost. It is non-excludable in the sense that no one can be excluded from enjoying or benefitting from it. It is a global public good whose benefits are shared by all individuals and institutions meaningfully connected to the global financial and economic system. By attempting to insure that banks have sufficient capital readily available, the Basel Accords contribute to the public good of global financial stability and the international regulation of systemic risk.\(^{38}\)

Global financial stability implies that a threat to any part of the system is dealt with as a threat to the whole system given the interconnectedness of modern financial systems. Financial history was described by the late economic historian, Charles Kindleberger, as a continuing cycle of “manias, panics and crashes” categorized by precipitating events leading to speculation; causing monetary expansion; reaching a speculative peak followed by a crisis, crash or panic; requiring the intervention of a lender of last resort and the post-crisis debate over lessons learned.\(^{39}\)

The prevention of future global financial crises is a work in progress. Global financial crises can result from minor domestic situations or from widespread international crises and wars, which engulf entire regions of the globe as in the Asian crisis of 1997-98. They may be caused by excessive domestic credit expansions, investment “bubble” collapses, unsustainable national budget deficits, speculative attacks on fixed exchange rates pegged to unsustainable levels, the withdrawal of “hot money,” balance of payments shortages of
foreign exchange, moral hazard crises, disorderly workouts of sovereign debt, or other causes.\textsuperscript{40}

Insuring global financial stability involves the strengthening of the banking system, the shoring up the confidence of investors and depositors, as well as protecting the public against fraud and financial crimes.\textsuperscript{41} Confidence is based on a bank’s maintenance of a stock of capital in adequate proportion to the amount of money that the bank has placed at risk in its investment and trading books. Once a bank’s stock of capital falls below levels required by the banking authorities, that bank must take prompt actions to reestablish adequate capital or the banking authorities will shut it down.

There is no such thing as capital adequacy in the absolute sense. After a bank failure, it is obvious that more capital would have helped the bank withstand the financial shock. However, as Schooner and Taylor observe: “There will always be a higher wave, a greater storm that could overcome a barrier of any particular height.”\textsuperscript{42}

Traditional banks essentially perform two activities: borrowing money and raising capital and, secondly, lending to nations, businesses, and individuals. Banks raise equity capital and borrow debt in order to lend and invest money. If they earn more on their lending than they pay on their borrowings, then they are profitable and create a source of credit to borrowers and a source of financial safety for those who have money to protect and invest.

There are three types of capital in the banking system: economic, regulatory, and actual.\textsuperscript{43}

**Investors and counterparties demand economic capital.** By definition, economic capital is chosen by shareholders without regard to regulation. **Regulatory capital** is the
minimum that banks must maintain by regulation. Actual capital is the capital chosen by bank shareholders taking into account regulatory constraints.

The more capital retained by a bank, the more likely the bank will be able to repay its depositors and the greater the confidence in the banking system. However, capital reserves cannot be invested and so reduce the returns that a bank can earn on its investments. Hence, there is an inherent conflict of interest between the mandate of supervisors to increase capital in proportion to the financial risks undertaken and the banks with a mandate from shareholders to reduce the amount of excess capital and increase earnings.

Within modern banking systems, in order to lend money (or invest in any assets), banks must retain “sufficient” capital to insure that depositors will be repaid upon demand or to provide enough of a financial “cushion” to protect a bank against unexpected losses. The borrowing may be either permanent in the form of stock from shareholders or temporary in the form of deposits from the money market or the public.

It is obviously in a bank’s self-interest to maintain capital sufficient to protect itself against a “run,” against unexpected losses and to deserve the confidence of investors and depositors. However, since capital does not earn the returns of an investment, the more capital that the regulators decide must be retained, the less profitable the financial institution. Thus, there has been a constant tug-of-war between banking regulators and the financial institutions.

Loans and other investments are assets that are inherently risky in that they may not be repaid or drop substantially (or completely) in value. There is a tradeoff between the
riskiness of the investment and the rewards that may be earned. The higher the risk, the lower the probability of the loan or investment being repaid as agreed. Bank lending creates a multiplier effect enabling other financial institutions to do the same while leaving a fraction of borrowed funds on reserve.

Risks faced by banks have always included market risk (from changes in asset prices that reduce the firm’s value) and credit risk (the risk of default based on a counterparty’s creditworthiness). Following the East Asian financial crisis, the credit risk measurement system within the Basel framework, was updated to include operational risk associated with any of the following seven categories: (1) internal fraud; (2) external fraud; (3) employment practices; (4) products and business practices; (5) damage to physical assets; (6) business disruption and system failures; and (7) execution delivery.

2.2.2. Bank Capital Regulation and Global Economic Growth

Capital adequacy is a key feature of a banking system in that it not only gives depositors and investors confidence in the “safety and soundness” of the banking system but also because changing levels of capital adequacy acts as an accelerator or brake on the engine of economic growth. The foundation of bank supervision is insuring that there is adequate capital, or other financial reserves, on hand to minimize the risk that the bank will default on its financial obligations to borrowers and lenders at the maturity of each transaction. Some governments extend their guarantees to the overall banking system to insure all of the “safety and soundness” of their financial systems.

Raising the minimum level of capital will make banks safer in the sense that they have more to guarantee the safety of deposits but will slow an economy by restricting the
volume of lending by banks. Lowering the regulatory capital minimum will enable banks to become more competitive by lending more aggressively but will detract from overall confidence in the banking system to weather any downturns in the business cycle.

In a system of fractional banking, banks are required to retain a small fraction of every borrowed dollar. This feature of the “fractional banking system” is known as a multiplier effect in the sense that the original deposit creates multiple loans and investments. Setting levels of capital in the banking system is analogous to the use of an accelerator pedal or brakes on a car: increasing capital levels results in increasing safety at the cost of slowing economic activity. Thus the ability to control the level of regulatory capital acts as a “brake” or an “accelerator” on the broader economy, just as the raising or lowering interest rates (or manipulating foreign exchange rates between currencies) influences the level of economic activity and increases or decreases in the rate of economic growth of businesses and households in the economy generally.

With the “procyclical” regulation of banking, when the economy is expanding, banks are allowed to reduce capital because there is less risk. However, when the economy is contracting, banks are required to increase capital since the risk of default is increasing. By increasing capital in a recession, banks are forced to reduce lending, which contributes to the recession--hence the term “procyclical”.

Banking regulation is “countercyclical” in the sense that when the economy is expanding, banks are increasing capital. However, when the economy goes into recession, banks would be allowed to reduce their capital ratios thus encouraging them to increase lending and hence countering the contraction of the business cycle. The markets may not be
willing to allow banks to reduce capital in the middle of a crisis and may even demand higher capital levels.

Basel I set the minimum capital requirement for banks (the percentage of risk-weighted assets to be held as capital) at 8%. The standard risk-weight categories used were 0% for short-term government bonds, 20% for exposures to OECD Banks, 50% for residential mortgages, 100% weighting on unsecured commercial loans, and 150% rating for borrowers with poor credit ratings. So if a bank held $100 in Treasuries, $100 in home mortgages, and $100 in commercial loans, it would have $300 in assets, but only $150 in risk-weighted assets (0% * $100 + 50% * $100 + 100% * $100); therefore it would have to hold $12 in capital (8% * $150). Looked at another way, the capital requirements are 0% on government bonds, 4% on home mortgages, and 8% on commercial loans.48

Regulation refers to the set of laws and rules applicable to banking. Supervision is defined as the monitoring by authorities of banks’ activities and the enforcement of banking regulations.49

Central banks and other financial regulatory authorities can be described as having two fundamental objectives: the microprudential and the macroprudential supervision of banking.50 Macropolicy refers to “the regulation of banking and provision of services to the banking system”. Monetary policy includes influencing interest rates and setting reserve requirements; foreign exchange rate policy51; performing the “lender of last resort” function in financial crises; and regulation of the global capital markets. 52

Macroprudential risk involves risks to the overall financial system. The term has been traced back to the 1970’s referring to the financial system’s stability and link with the
macroeconomy. Over time, the specific focus of macroprudential concern has shifted from excessive lending to developing countries, the impact of financial innovation, and the development of capital markets, to the influence of regulation on the procyclicality of the financial system (reinforcing rather than counterbalancing worsening economic conditions) and the implications of the failure of systemically significant institutions.53

To achieve “safety and soundness” standards in the United States, banks follow the CAMEL standard.54 The CAMEL System has two basic aspects: (1) an assessment by bank examiners of five key aspects of a bank's operations and conditions (capital adequacy (‘C’), asset quality (‘A’), management (‘M’), earnings (‘E’), and liquidity (‘L’)); and (2) an overall rating on a one to five scale of the bank's condition and soundness according to these five categories. In addition, the Federal Reserve utilizes a component and a composite rating system for bank holding company units, evaluating the following elements: bank subsidiaries (‘B’), other (nonbank) subsidiaries (‘O’), parent company (‘P’), earnings (‘E’), and capital adequacy (‘consolidated’).55

Banks constantly seek to improve their profitability through financial innovations. They tailor loans and deposits to the needs of their commercial and household clients. In terms of attracting deposits from clients, competitiveness requires paying the highest rates for a given maturity. Competitiveness in lending requires extending credit at the lowest interest rates determined by the perceived creditworthiness of the borrower and the maturity (or tenor) of the financial commitment.
2.2.3. The Trade-off between Financial Stability and Economic Competitiveness

“There's a balancing act that the politicians need to play, between making the system really safe and keeping it relevant,” said Mark Flannery, a finance professor at the University of Florida in Gainesville who has tracked Basel for two decades. “If you restrict the banks too much, financial activity will be curtailed or it will shift to non-banking institutions, making the rules irrelevant.”

To meet customer demands, banks tailor financial products or devise entirely new financial instruments. Financial regulators must be kept informed of such activities so that they can evaluate whether new or modified guidelines and regulations are required to maintain standards of safety and soundness. Banks devise financial instruments to be traded on public exchanges or in private bank-to-bank exchanges. Banks respond to competitive challenges and invest all of the funds they control by reducing the amount of money that must be kept idle as required by the banking regulators.

In addition to the competitive pressures on banks, financial regulators interact with the capital markets themselves. Banks are no longer the only financial institutions to which institutions and individuals turn for borrowing and lending needs. They also turn to global capital markets where individual needs are met by packaging them into securities that are traded either on an organized exchange where transactions are fully publicized or in closed marketplaces between financial intermediaries (“over the counter”).

The competitiveness of banks is often described as “leveling the playing field” meaning reducing the competitive advantages of one’s business competitors (or, increasing one’s own competitive advantages) on a local, national, or global level. In the banking industry, increasing one’s competitiveness also influences a bank’s attractiveness as a takeover
target. Other pertinent expressions are being “pro-competitive” (seeking support for one’s own competitive advantages by lifting regulations) and “anti-competitive” (imposing regulations that benefit the competitor).

Competitiveness is not only the competitiveness of individual banks but also the attractiveness of the global financial centers like New York, London, and Tokyo. Thus “leveling the playing field” becomes a global issue that requires that one location in the global financial system does not achieve competitive advantages over others. Like air pollution, it cannot be addressed by a single state or group of nations.

The overriding concern in the United States Congress in the early 1980’s when debating the harmonization of capital adequacy was not with the safety and stability of the international banking system but with “leveling the playing field” against the banks of those states seen as having unfair competitive advantages. To see how concerns over a level playing field were playing out, remember the dramatic surge in Japanese commercial power in the 1980’s and especially the rapid growth of Japanese banks that seemed to threaten to dominate the world market. The downside to imposing tougher regulations is that it encourages a “race to the bottom” where business moves to jurisdictions without onerous regulations.

2.3. The Challenges Facing Financial Regulators

The Basel Accords not only affect the competitiveness of individual banks but that of national and regional economies. Capital standards increase the cost of capital to the least creditworthy nations and enterprises and to poorly rated (or unrated) business in general. With banks responding to these competitive pressures, how can the regulators
maintain their effectiveness as guardians of the safety and stability of the financial system, given the increased appetite for risk shown by financial institutions and the competitive pressures on banks to increase earnings by investing in lower quality assets?

There are two basic approaches: (1) regulate the instruments themselves and (2) regulate the capital of the banks to prevent over-leveraging.

The regulation of banking can be thought of as being in conflict with the basic interests of banks. As previously noted, a bank’s foremost goal is to earn profits on all of the funds it controls. Some funds are in the form of stockholder’s equity invested by the owners of the bank. Some funds are raised in the form of deposits taken from individuals, corporations, or other banks. This is the essence of the financial regulatory dilemma: an increase in the capital requirements of bank will increase the stability of the bank but decrease its profitability and competitiveness. A decrease in capital requirements will increase profitability and competitiveness but decrease the stability of the banking system, since there is less of a cushion against unexpected losses and less confidence in the marketplace.

The goal of banking regulation is to ensure that the amount of capital retained by the bank is within its guidelines as to how much capital should be kept by the bank in proportion to how much of the bank’s cash is used to acquire assets. However, the definition of what constitutes capital (and other related issues) is far from a settled issue.

When an individual bank is undercapitalized, the regulators may either close the bank or force it to merge with a stronger institution. Many governments to maintain confidence in the banking system by insuring deposits up to a certain amount have established
insurance funds. When there is a fear that the entire banking sector is undercapitalized, confidence disappears, and the credit markets can “freeze up,” stopping the vital flow of credit not only to the financial sector but also to businesses and households.

The way in which those opposing forces are balanced reflects the quality of regulation, or of governance. Too much emphasis on stimulating competitiveness reflects the favoring of private over public interests (regulatory capture); too much emphasis on stability, safety, and soundness protects the public interest in financial stability while leaving financial institutions at a competitive disadvantage.

The governance of global finance presents many controversies for the study of Global Governance. This chapter will discuss the Global Governance paradigm and identify the controversies that the Basel Process represents in the literature on Global Governance. This chapter will outline some of those challenges, and then there will be a further discussion of them in future chapters.

International Law and International Relations (IR) formed a single academic discipline within Political Science until the end of the First World War. According to the disciplinary historian, Brian Schmidt, both fields were founded on the concepts of sovereignty and anarchy. To legal scholars, sovereignty existed within territorial limits that demarcated where political and legal authority was exerted. To political scientists, the focus was above the domain of the sovereign state where no higher central authority existed. This gave rise to what Schmidt described as “a discourse of anarchy” which has been pursued by scholars of international relations since 1919.

In the United States, IR evolved in part into the subjects of International Political Economy (IPE) and International Security. Global Governance emerged as a subfield of IPE as scholars began to emphasize the importance of domestic institutions and non-state actors alongside the traditional role of states on the international stage. IR remained a very state-centric subject in which the realist school was ascendant, dominated by such theorists as Hans Morgenthau and Kenneth N. Waltz. In the 1970’s, IR theorists...
concentrated more on the variety on non-state actors who were coming into prominence in international economic integration.

The study of international politics continued to concentrate on the “realist” concerns of the “high politics” of state-to-state relations focused on the handful of elites officially involved in the formulation and execution of foreign policy. However, the postinternational perspective on Global Governance highlights the role of non-state actors such as NGOs in international institutions. Postinternational change is the product of simultaneous processes of the “fusion and fission” of authority.

Postinternational theory sees the world today (also historically) as inhabited by countless actors of many different types that reflect different identities, are differentially engaged in countless issues, and exercise effective authority in particular domains and contexts. Involved are relations between the regulators and the regulated, between principals and agents, legislatures, national finance ministries, and central banks, between the powerful and the powerless, between the represented and the unrepresented, between those who supply credit and those who demand it.

Global Governance Theory (GGT) has evolved from the literature that divided a world fragmented into formally sovereign nations into two major schools of thought: the international society approach expounded by Hedley Bull (which “remains quintessentially a form of State-Centric Realism” and the international regime approach. One of its foremost proponents, Robert O. Keohane, described regime theory and the prevalence of regimes as “a function of the rational choice of their members, who enter them to constrain their choices and reduce the transaction costs of cooperation in an
otherwise anarchic international society." Jones has distinguished four general types of international regimes: quasi-administrative organizations for technical regulation; the ‘universal’ institutions of the United Nations; the specialist financial agencies of the “Bretton Woods system”; and the relatively informal but, often regular, meetings of groups of states with common interests.

Global Governance Theory is the antithesis of the formal logic approach that characterizes much of contemporary theory. GGT does not seek to develop narrow and more parsimonious theories but rather is as fundamentally eclectic and contradictory as the world it seeks to describe. It is more a way of looking at global affairs than a set of principles, rules, and variables that can be “operationalized”.

One of the major concerns of the Global Governance literature is how global public goods are supplied to deal with issues that governments cannot provide without involvement from non-governmental actors. According to James Rosenau, it is the supply of “governance without governments”. That is, this approach to the study of international affairs emerges from the evolution of the international system which governments have, to some extent, created by their own actions. As Cutler notes, states have not been helplessly stripped of their authority by the rapacious forces of globalization. Rather, firms have taken up those functions that have been “voluntarily abandon[ed by]… public authorities due to the force of liberal ideology, globalization, or the lack of state capacity to manage current issues” or by “large-scale privatization of state holdings, the delegation of regulation to industry associations and increased reliance on market forces in general”. 67
In Global Governance Theory, the elements of governance include not only formal and informal institutions but also norms, customs, loyalties, motivations and goals of any individual, community, or polity that can be thought of as a participant in global affairs. Global Governance Theory considers the “relocation of authority” as an attempt to take into account that what is governing global affairs today is no longer just national governments. Some institutions created by government are helping to carry out governance, but there are more participants in the policy formation and implementation process than ever before. Global Governance Theory differentiates between governments and governance and views the existence of private international authority as “forms or instances of government”.68

Global Governance Theory puts all of these actors, public and private sector, formal and informal institutions, corporate and individual, into the scope of the theory and focuses on issues which are “global” in scope such as international security, social and human rights, the global environment, the global economy and development, cyberspace, crime, drugs and corruption. The larger challenge facing Global Governance Theory is that “effective public governance is… in the longer term… a matter of securing and sustaining legitimacy”. 69

3.1. Concepts in Global Governance Theory

Global Governance Theory is concerned with the effective management of the global system. It attempts to deal explicitly with the implications of globalization on the authority structures that manage the global system.
Globalization is related to the earlier concept of international integration but takes into account advances in technologies of communications, travel, the global organization of corporations, and many other factors. According to Keohane and Nye, two of the most influential writers on the subject, globalization is characterized by an ebb and flow between increasing and decreasing globalism amidst a world involving “networks of interdependence at multicontinental distances”. They distinguish several equally important forms of globalism: economic (business and financial) globalism; military globalism; social, cultural and religious globalism, and environmental globalism.

Central to the analysis of Keohane and Nye is the concept of Complex Interdependence which consists of “a hypothetical world with three characteristics: multiple channels between societies, with multiple actors, not just states; multiple issues, not arranged in any clear hierarchy; and the relative irrelevance of the threat or use of force among states linked by complex interdependence”.

The Complex Interdependence concept seeks to be all encompassing by incorporating the creation of new areas of public policy that need to be addressed on a global basis. It assumes that supranational institutions have taken on a “life of their own” and are not simply instruments of the participating governments. International non-governmental institutions (INGOs) are the most widely known of this extra-governmental set of participants. Over the 20th Century, the number of INGs has grown from a handful to almost 6,000. INGs affect national governments, multilateral institutions, and national and multinational corporations in four ways: setting agendas, negotiating outcomes, conferring legitimacy, and implementing solutions.
The preceding overview of Global Governance Theory key does not do justice to one dimension that serves as the basis of Rosenau’s theory, that is, the intensiveness, or depth, to which authority structures extend. This should not be thought of as a one-way top-down transmission of authority in the sense which “democratic centralism” played in the Marxist-Leninist theories of socialism and command economies. Rather, Rosenau’s theories begin from the “bottom up” instead of the “top down” approach of realist IR theories. That is, he begins with the “micro-level” – the capacities and orientations of individuals and small groups - that result in a general “crisis of authority.” Rosenau asks us to consider the possibility that citizens of polities (not of nations) have developed the “skills” to appreciate that there are tensions pulling them in two opposite directions: towards greater global integration and towards loyalty to “local” spheres of authority. The combination of these two forces creates the phenomenon of “fragmegration”.

Rosenau recognizes that citizens are no longer, in the industrialized world, willing to accept the imposition or subjugation to ideologically justified regimes that rule by sheer force.

Informational globalism increases the political skills of citizens. Hewson dates the direct production of “globalist information” and the call to share knowledge to creation of the International Institute of Agriculture in 1905 that issued a monthly bulletin of “agricultural intelligence”. Global Governance led to attempts at early warning systems, surveillance, and transparency that lead to informational globalism. Political skills are only valuable to individuals who are concerned with global affairs: they coalesce in global social movements, “groups of people around the world working on the transworld plane pursuing far reaching social change.” The prima facie evidence for the centrality
of this observation to Rosenau’s “turbulence model” is the collapse of the Soviet bloc at the end of the 1980’s followed by the almost-bloodless disintegration of the Union of Soviet Socialist Republics into 13 new “political spaces.”

Globalization does not proceed in one direction only. It may move forward and it may move backwards. It is not a “top down” phenomenon dictated from the heights of the state on the rest of society but also a “bottom up” phenomenon. From the post-international perspective, “sovereignty-free actors” (SFAs) have not been elected to represent anyone; they cannot be recalled from office for malfeasance or incompetence. SFAs possess increasingly potent “political skills” resulting from the spread of higher education and various means of mass communications and social networking as seen so unexpectedly (and with such monumental impact) in the “Arab Uprising of 2011.”

3.1.1. Spheres of Authority

Accelerating change is producing an increasingly complex universe of actors in global/local politics. Ferguson and Mansbach call them “polities”, while Rosenau prefers the term “spheres of authority (SOAs).” Polities are collectivities with a significant measure of identity and institutionalization, a degree of hierarchy in their organization, and the capacity to mobilize persons and groups for political purposes (value satisfaction). Some entities clearly meet these criteria. For instance, many countries, international institutions, TNCs, major NGOs, and criminal and terrorist organizations are polities. By contrast, most markets are not polities, because they lack the requisite identity, institutionalization, and hierarchy. Rosenau distinguishes four types of Spheres of Authority.78
The “Established” Spheres of Authority is the sphere of the traditional interactive policies of state-to-state and state-to-international-governmental-organization relations. To many students of IR (and probably to most non-students of IR), this is the only sphere that exists or matters. “The state remains as the ultimate guarantor of the ‘rights’ of global capital, i.e. the protection of contracts and property rights”. 79

The “Accommodative” Spheres of Authority is created between national and non-state actors in such a way that “the transformed loci of authority [is] sufficiently clear-cut to enable all concerned to contain their differences and accommodate to each other”. Cutler, Haufler and Porter recognize the existence of “accommodative” SOAs in the framework of governance for international economic transactions. They point out that such spheres of “private authority” have existed for centuries. What they are describing is a new phenomenon in the evolution of IR from the “older formal institutionalism…which had focused primarily on codified international law” with a newer formal institutionalism that “incorporates an attentiveness to the roles of power and anarchy in explaining world affairs”. 80 They describe the varieties of cooperative arrangements among firms in six categories.

Coordination services firms coordinate other firms such as legal, insurance, stock exchanges, and other financial clearinghouses. Informal industry norms and practices create a natural “harmony” because of mutually desired outcomes. Production alliances, subcontractor relationships, and complementary activities encourage cooperation in joint production of goods or services between firms that normally compete. Cartels coordinate their output and prices. Business associations set standards and represent their members to the industry through domestic and international lobbying. Finally, private
international regimes create “soft law” in the form of voluntary and formally nonbonding agreements to govern their activities.81

This cooperation between private sector actors has become “authoritative or government-like… thus challenging our notions of the character of political authority itself”.82 What is most surprising is the cooperation between firms in the international sphere that are supposed to “compete ruthlessly in the marketplace to attain the highest profits possible”.83 This might prompt the reaction that their cooperation is designed to increase the oligopolistic control over the market. If the result is to increase the cooperation between producers of goods and service, it is of benefit to the general welfare.

These SOAs arise because the expertise to regulate industries and activities in a specialized knowledge-based economy is not necessarily possessed by government bureaucrats. These SOAs create “rules of the road” without which markets cannot operate. They result in decreased transactions costs and a degree of certainty about the future.

The alternative to either ignoring or delaying regulation when new issues emerge is effectively delegating whatever rule-making authority is exercised to the private sector.

In “Contested” Spheres of Authority, the distribution of authority is contested to such as extent that “accommodation is not a goal and the threat or use of force is not precluded”. In “Transient” Spheres of Authority, authority emerges from strictly domestic activities that result in cross-border spillovers. Because the consequences of a spillover get resolved rather than becoming ongoing issues, the locus of authority remains unclear and may prove “transient”.
3.1.2. Networks of Private Authority

A primary interest of Global Governance is the study of how governance functions are effectively carried out in the absence of formal governmental institutions. The concept of networks of private authority is used extensively to highlight cooperation between private interests in meeting the demand for governance which government cannot or will not supply. These networks are characterized by extensive cooperation among private institutions in rule making, standard setting, and sector-organizing.\(^{84}\) They consist of informal industry norms and practices; coordination service firms such as multinational law, insurance and management consultancy firms and financial clearinghouses; production alliances requiring subcontractor relationships and complementary activities; cartels; business associations; and full-blown private regimes; consultancy firms and financial clearinghouses.\(^{85}\)

Hall and Biersteker argue that there are three types of networks of private authority.\(^{86}\) Networks based on “market authority” are sanctioned either by governments or enjoy a measure of legitimacy because of the historical role of firms and associations. Networks based on “moral authority” gain legitimacy from the accumulation of specialized expertise in a given subject matter. Finally, transnational criminal or terrorist organizations based on “illicit authority” play an important (though pernicious) role in world politics.\(^{87}\)

One can conceptualize of the governance of financial globalization in terms of a multilevel bargaining process.\(^{88}\) In the literature, Global Governance consists of a set of rules, institutions, informal groupings, and cooperation mechanisms. Global Governance
includes supranational institutions such as the international financial institutions, as well as the informal groupings like the G7, G20, G20 and G24 that have emerged as forums for global coordination over important issue-areas that are beyond the capacity of individual governments to address alone. Not the least of these concerns is the regulation of cross-border financial markets.89

Global governance of financial markets on the national level involves nations, legislatures, judiciaries, bureaucracies, central banks, national finance ministries, businesses, academic experts, mass media, and others. On the international level, it requires international financial institutions, including the familiar Bretton Woods institutions and other institutions and less-formal arrangements. Their central task is the harmonization of capital adequacy standards and other safety and soundness measures.

3.1.3. International Soft Law and the Basel Accords

The Basel Process, an exercise in the making of international “soft law,” is fascinating in that “though the Basel process does not legally exist, it has gone further than almost any other standard-setter”.90 Tarullo describes this as “a development that is unusual if not unprecedented, domestic regulatory standards elaborated in a non-legally binding international arrangement among a dozen countries have been adopted by more than 120 countries that did not participate in the formulation of the standards”.91 Banks, for example, and even some insurance companies, often seek to adopt the Basel Committee’s capital standards to signal that they are solvent and well capitalized, as well as to assure investors that they meet the most stringent regulatory oversight92
Soft law means “guidelines, policy declarations, or codes of conduct that set standards of conduct but are not legally binding.” Soft law is “an international rule created by a group of specific national authorities and adopted into their nations' laws or administrative codes.” That is, the international regulation of banking is not a matter of international law codified in treaties, ratified by legislatures, and debated by the public. It is devised by specialists in the field of banking regulation and negotiated with their counterparts in other countries. From that perspective, it is an example of the “horizontalization” of Global Governance where structures of governance are negotiated between specialists with expertise in a very specific area.

Since the Basel Accords are international soft law, the intellectual puzzle in studying them is to understand how compromises are arrived at and then refined and renegotiated. How are the regulations of participating nations reconciled into a comprehensive multinational agreement? Are they simply handed down by a small opaque assemblage of nameless bureaucrats? This is the crux of the international political economy issue: whose interests prevail in the final product? Whose interests suffer? Are there means for the losers to be compensated by the winners? What are the sources of authority in international banking regulation? How did this international soft law regime come about? What are the incentives to join? Is it desirable to replace international soft law with formally negotiated, ratified, and (most importantly) enforceable treaties? Is it politically feasible? Who would be responsible for enforcing such binding treaties? Would there be a “dispute settlement mechanism” built into to international financial agreements as there is with international trade negotiations?
The Basel Committee is an example of what IR theorists Keohane and Nye call a “policy network” which supports “transgovernmental activity” (“sets of direct interaction among subunits of different governments that are not controlled or closely guided by the policies of the cabinet or chief executives of those governments”). According to Slaughter, “harmonization networks that “bring regulators together to ensure that their rules in a particular substantive area conform to a common regulatory standard”. There are two types of government networks: the formal type composed of transgovernmental regulatory organization and, second, the less formal type of network formed through agreements between domestic regulatory agencies.

The networks exist between regulators with overlapping authorities within a national government, between the national and state governments, between regulators in different countries, between the economic and political leadership of different countries, between international financial institutions and nations. As Brummer notes, “for nearly a decade, most scholars, guided by the pioneering work of Anne Marie Slaughter, have described the international financial system as consisting of collegial ‘networks’ that foster collective problem-solving and innovation through interactions of regulatory peers.” Supervisory networks are discussed in Chapter 6 in connection with Pillar 2.

3.1.4. The Basel Accords as an International Trade Negotiation

Federal Reserve Governor Daniel Tarullo (the consummate “Basel insider”) has described the Basel Accords as more of an international trade negotiation rather than an exercise in negotiations over purely regulatory matters. In other words, the interests of the parties influence the outcome more than the pure efficiency of the regulations on the
banking system. Basel exhibits the characteristics of an international trade negotiation with give-and-take between parties analogous to the “Green Room” process of international trade negotiations where a relatively small number of countries decide the divisive issues. However, this excludes many newly active participants in World Trade Organization (WTO) negotiations and thus detracts from the building of consensus.\textsuperscript{102}

The current system provides input into the decision-making process by a number of large developing countries but excludes representation of the interests of the majority of WTO members. Ironically, these largely developing countries are the ones being asked to undertake more substantial liberalization of their trade barriers and reform of their trade practices than their industrialized partners; they deserve more of a voice in the WTO’s decision-making process. This analogy between the Basel Process and international trade negotiations will be discussed below. Negotiations of the Basel Committee are done behind closed doors without records of discussions, debates, and votes.

\textbf{3.2. Controversies of Global Governance Reflected in the Basel Process}

The Basel Accords are the premiere efforts in the governance of financial globalization. This section will describe some of the controversies posed by the Basel Process in the Global Governance literature.

\textbf{3.2.1. Controversies Based on “Stages of Financial Development”}

At the inception of the Basel Process, there was no universal agreement on how to measure capital adequacy. The original capital adequacy regulations varied from country to country with such basic differences in the definition of capital adequacy as the ratio of liabilities to capital or the ratio of assets to capital.
How evolved are risk management regulations and practices? Is the central bank independent from (or an appendage to) the executive or legislative branches? How financial systems develop over centuries depends on the national characteristics of the economy, political system, cultural norms, endowment of natural resources, technological advances, educational and entrepreneurial skills of the citizenry, and the degree of integration into the international economy. In order to be effective, a regime for the governance of global finance should be flexible enough to be applied to all financial systems.

A state with a small number of institutions could adopt a regulatory system that allowed for a great deal of discretion on the part of regulators because they maintained close relations with the banks. This was true of the British financial industry where the Bank of England (the “Old Lady of Threadneedle Street”) was regarded as having the power to regulate by the use of the “raised eyebrow” to express implicit disapproval of a bank’s actions. By contrast, the banking system of the US consisted of thousands of banks and so standards had to be much tighter because there was not as much opportunity for personal relationship to develop between the banks and the regulators. The US has tens of thousands of banks and a deep distrust of centralized financial power.

**Characteristics of the national economy.** There are different types of economies: industrialized, agricultural, service-sector oriented, heavily reliant of export industries, lacking in raw materials or endowed with an abundance of raw materials, and possessing a concentration of large corporations or small industries. Industries may also be financed through traditional bank lending or via capital markets.
Role of the government in the national or global economy. Are governments liberal “free market,” centralized authoritarian, or of the “corporatist” variety with a leading role played by the business sector? What role does the state have in the economy especially in times of financial distress or crisis? How extensive is the role of government in regulating industry? How burdensome is corporate governance?

3.2.2. Controversies Inherent in “Multilevel” Negotiations

As a topic of concern in the Global Governance literature, the Basel Process has demonstrated the difficulties in assembling and holding together national coalitions of regulators and the regulated industry. This will be discussed in Chapter 6 in connection with Pillar 2, the Supervisory Review process, and the transnational coordination between national supervisors.

3.2.3. Controversies over National Regulatory Styles

Helleiner argues that the Basel Process involves “contrasting national perspectives on international standards relating to issues such as accounting, corporate governance, credit rating, and hedge fund regulation [that in turn] reflect distinct features of national varieties of capitalism.”¹⁰³ There is indeed a spectrum of practices in banking between those countries with a very liberal interpretation (Japan) of capital adequacy to those with a very conservative interpretation (Germany).¹⁰⁴ The Japanese concept was so loose (to foster their own state-led capitalism) that they allowed banks to count unrealized profits and capital investments by related insurance or other types of corporations in a bank’s capital structure. The Germans, on the other hand, would only accept fully paid-in shareholders equity in their definition of capital.¹⁰⁵ Will such differences inevitably
result in a regulatory agreement that is so full of loopholes as to render the final product an expensive, time-consuming waste of time? One wonders how banking supervisors recognize, accept differences in national approaches, and continue to make progress towards the next set of Basel Accords. Indeed, cynics might argue that it would be better if they abandon their efforts altogether.

3.2.4. Controversies over Global Standards and National Business Cycles

Keeping in mind that regulating capital levels in the banking system has the effect of accelerating or decelerating economic growth, what will the Basel Committee (or Financial Stability Board) recommend if some economies are contracting into recessions while others are expanding, or if all economies are contracting? Including “mark-to-market” accounting in the regulatory capital adequacy guidelines exacerbates negative economic trends. If banks attempt to raise capital when the economy is in recession (or, if mark-to-market accounting is in effect which requires that they raise capital to offset the unrealized losses on their investment portfolios), this may very well have the effect of making a bad situation worse (“procyclical”)

The opposite approach, countercyclicality, allows banks to increase lending as the economy worsens (as long as their capital stays within a certain range) and to reduce credit creation when the economy is overheating. While it is desirable to counter contractionary cycles by encouraging banks to increase their lending to businesses and households, this calls for a major enhancement in the financial regulatory power of global financial regulators. In fact, it sets up a direct challenge between the powers of independent central banks and unelected global regulators.
States experience **economic expansion and contraction** on their own schedules. Not all economies are in recession at the same time or expanding at the same rate. Not all were affected by the Panic of 2008 and ensuing Global Financial Crisis. To what extent do the individual economic circumstances influence a country’s willingness to accept the proposals advanced behind the closed doors of the Basel Committee?

### 3.2.5. Controversies over Global Standards and National Deregulation Efforts

An excellent example of this type of controversy occurred in the early 1980’s where the United States and Britain (under Reagan and Thatcher respectively) pursued deregulation while France under Mitterrand nationalized its banks in an attempt to achieve “socialism in one state.” The separation of commercial and investment banks in the United States (since the Glass-Steagall Act of 1933) is the exception to the rule of “universal banking” prevalent in Europe. How could a global regime have been implemented for both types of banks? How can the Basel capital adequacy regime accommodate the dramatic changes resulting from the 1999 abolition of the Glass-Steagall Act under the Gramm-Leach-Bliley Act (or, the Financial Services Modernization Act of 1999)? Did that institutional change result in the major effort to amend Basel I? What was the impact on the quality of Basel II as a banking supervision package when banks sought to reinvent themselves as “financial supermarkets”?

### 3.2.6. Controversies over Participation in Global Financial Governance

“Legitimacy, at root, is the widespread belief that a Global Governance actor has the right to exercise whatever authority it does. That an actor’s constitutionality, state pedigree, and internal democratic character and processes may influence belief, as well as such matters as the actor’s reputation for moral authority or possession of expert knowledge.
However, legitimacy derives fundamentally from a Global Governance actor’s ability to deliver the goods that its constituents (members and wider publics) need and want. Success in doing so, over time, establishes a track record, tends to attract broader support, identity, and even loyalty. Consistent failure, obviously, courts the reverse.”108

Any discussion of Global Governance inevitably has to deal with the issue of the “democratic deficit” which reflects the unrepresentativeness of the process of arriving at global agreements. How can so many countries with so little input from many of them implement such an agreement based on international “soft law”?

Is it the nature of the modern global banking system that the only way to attract more business and become more competitive is to adopt the highest standards? How sincere have the efforts of emerging markets to adopt Basel Accord standards been? Why did a “race to the bottom” not occur even though the lowering of standards supposedly attracted more banking business?

This controversy in the Global Governance literature (and the next topic – changes in “structural power” in the global economy) will be discussed in Chapter 7 in connection with the implications of the enlarged role of the G20 in the Basel Process as a direct result of the Global Financial Crisis.

3.2.7. Controversies over Global Changes in “Structural Power”

As centers of power and production spread from advanced industrial to emerging market economies, how can global financial policymaking be made a more inclusive process? How can the Basel Process, originally negotiated between only two nations, accommodate the shift to a “multipolar” global financial system? How will the members of the Basel Committee reevaluate their contribution to global financial stability in the
aftermath of the Global Financial Crisis given the entrance of the G20 into the Basel Process?

In terms of the international monetary system, China has become one of the world’s major creditors while the United States has become the world’s greatest debtor. China in particular has developed a “symbiotic” relationship with the United States in the past decade. What exactly is the attitude of China towards the Basel Process? Walter argues that China has wholeheartedly embraced the Basel regime for tactical reasons as a “means of setting an ambitious and externally validated reform target for a financial sector that has been an Achilles heel of Chinese economic development (and of emerging Asian economies generally).” Adhering to Basel standards will assist in the global expansion of China’s banks and, Walters argues, accelerate financial reforms that promote the domestic economic and social stability.

These questions are raised now to add them to the list of in the literature on Global Governance. They will be discussed further in the concluding chapter on the implications of the new role of the G20 in the governance of global finance.

3.2.8. Controversies over Financial Products and Risk Management Techniques

Like any competitive industry, new financial products are constantly developed to meet the needs of customers. A central concern is how can the governance of global finance evolve and adapt to continual financial innovations. One of the challenges for financial regulators is to assess the potential risk added to the financial system. This topic will be examined in Chapter 7 on the “Unintended Consequences” of the Basel Accords.
3.2.9. Controversies over Demands for Industry Self-Regulation

Like any industry, the financial industry pursues self-regulation to increase its competitiveness. It does so by placing reliance on “best practices” which allows the industry to retain flexibility and encourage continual competitive innovations.112

Banks are not simply objects of financial regulations lacking in the power to “capture” legislators to ensure that legislation favors the interests sought by the lobbyists. What is the role of business in shaping the debate, influencing the ongoing process of testing and evaluating this body of international soft law?113 As Tsingou asks, have Global Governance efforts shaped business practices in the financial industry or have the regulations been shaped to fit the business practices that they are intended to govern?114 What is the relative power of the financial industry to advance its own political and economic agenda?

3.2.9.1. Regulatory Capture, Public Choice and the Basel Accords

To what extent is the financial regulatory system part of the “network of private authority” described in the Global Governance literature? Who shapes, and who primarily benefits from, the regulations in the Basel Accords?

If the financial regulatory system is a Sphere of Authority as described by Rosenau, what is to prevent or moderate the exercise of supervisory powers from sliding into Regulatory Capture? Does the national legislature exercise an effective oversight role over the financial regulators? Do its legislators possess the specialized expertise to understand the intricacies of financial regulation? What is the influence of doctrinaire populists whose rant against the regulators or institutions such as the central banks?
This topic can be divided into two schools of thought, the Public Choice School and the Regulatory Capture or Economic Theory of Democracy. Elaboration of the latter is attributed to George Stigler\textsuperscript{115} and the libertarian school championed by the University of Chicago and the Rutgers University graduate, Milton Friedman.\textsuperscript{116} It is a powerful argument against the ability of government to solve social problems and market “externalities”.

Do public institutions favor private interests or public interests? The Public Choice School sees regulators as pursuing the public interest. Public choice assumes that regulation seeks to advance the public interest by achieving the greatest good for the greatest number.\textsuperscript{117} Theories based on a public-interest account of regulation hold that regulation is necessary to cure “market failures” and “externalities,” to protect the public from monopolies and the abuse of private economic power. The Regulatory Capture School sees regulators as pursuing private interests. A theory of regulation should address the motivation of the actors, the behavior of the processes, and the nature of the outcomes.
The two basic paradigms in the literature on regulation may be summarized in the following chart:

<table>
<thead>
<tr>
<th>Type of institution</th>
<th>Acting in whose interest…</th>
<th>Public Interest</th>
<th>Private Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public institution</td>
<td>1. Public Choice school (&quot;Burkean&quot;)</td>
<td>Public Interest</td>
<td>Private Interest</td>
</tr>
<tr>
<td>Private institution</td>
<td>2. Regulatory capture school</td>
<td>Private Interest</td>
<td>Public Interest</td>
</tr>
<tr>
<td></td>
<td>3. Private groups devoted to advancing public goals</td>
<td>Private Interest</td>
<td>Public Interest</td>
</tr>
<tr>
<td></td>
<td>4. Profit-making institutions</td>
<td>Private Interest</td>
<td>Public Interest</td>
</tr>
</tbody>
</table>

For public choice theorists, regulatory capture occurs because groups or individuals with a high-stakes interest in the outcome of policy or regulatory decisions can be expected to focus their resources and energies in attempting to gain the policy outcomes they prefer, while members of the public, each with only a tiny individual stake in the outcome, will ignore it altogether.\textsuperscript{118} Regulatory capture occurs when resources devoted to a particular policy outcome "capture" or influence the staff or commission members of a regulatory agency to such an extent that the preferred policy outcomes of the special interest are implemented.
Regulators are motivated by either private goals or “Burkean” goals. Private goals are those that enrich ones’ self. They are somewhat prevented by conflict-of-interest and anti-corruption laws. To further one’s own career, regulators may seek to be captured so they have someone to work for after leaving public service. Burkean policies or actions are acts undertaken by a regulator without the possibility of fostering gains in general support.\textsuperscript{119} They are the acts of courageous leaders who put their careers on the line to thwart some public swell of sentiment that they perceive is not in the national interest.

Capture is about the domination of the regulatory process and not about the motivation or about the ultimate goodness of policy. Another assumed source of regulatory capture is their “corporate mind meld” in that the regulators and regulated industries all have the same values, goals, understanding about how the system works. To prove that capture occurred we need to prove the existence of a group that would be specifically benefitted by the policy or act and the identification of an offer of support quid pro quo by that group to the regulator in a position to act or to influence the policy.\textsuperscript{120}

Levine and Forrence incorporate the variable of monitoring costs (how expensive it is for one political actor to monitor a decision by another actor) and the concept of “slack” to describe the ability of regulators to pursue private interests depending on the visibility. Slack allows policy discretion that can be used to favor special-interest groups. Slack shields officials from accountability.\textsuperscript{121}

In a world free of information and organizational costs, slack would not exist, and regulators could neither be captured nor indulge themselves in following their consciences contrary to the wishes of the polity. With monitoring costs, if they are so
high as to prevent A from monitoring B, then B will have no incentive to conform behavior to A’s views. If there are *no monitoring costs* to study the actions of a regulator (all findings aired in public), there will be no slack and little chance of regulatory capture. Depending on the motivations of the regulators, slack can *either* lead to Burkean regulation *or* regulatory capture. Slack can be reduced by “incumbent self-publicity” or “political competition”. This energizes the press to ferret out regulatory behavior that, if known to the public, would force regulators to change their behavior.

In sum, the Levine/Forrence hypothesis is whether a regulator has been captured or not is a function of whether slack has been drastically reduced by moving an issue onto the public agenda. If the issue is or can be gotten on to the public agenda, we would expect general-interest policies or acts instead of capture.

While Basel II likely will apply to foreign–based banks in their home countries, the specifics of the rules and their implementation in other countries will differ from those in the United States, in part, because Basel II identified a number of areas for national discretion. National discretion reflects the Committee’s awareness that various features of national banking law and practice may require somewhat different treatment in capital adequacy regulation.

### 3.2.9.2. Regulatory Capture and Banking Supervision

States create banking regulations and empower banking regulators to examine the books of banks. Barth, Caprio and Levine characterize the distinction between public interest and private interest (regulatory capture) schools of thought as follows. In the public interest view, market imperfections do exist in financial markets that bank supervisors do
attempt to overcome, for the single purpose of improving the operation of banks. In the private interest view, powerful supervisors act in their own self-interest rather than to overcome market imperfections. In the private interest view, regulators are pressured by politicians to lend to politically connected firms and powerful banks seek to “capture” bank regulators who will act in their interest rather than those of society at large. The final element of the regulatory capture puzzle is that political and legal institutions are generally unable to contain these forces.124

Barth, Caprio and Levine distinguish **systematic corruption** from **venal corruption**. An example of the former is using the resources of the banking sector to buy political support while the latter consists of keeping some small amount for their own pockets.125 Are financial regulators trained in special programs to produce high quality banking supervision, or are they chosen for their loyalties to a patron in government or business? What is the retention rate for financial regulators? Do they tend to spend long careers in regulation or short tenures leading to lucrative positions in the financial industry being regulated?

How can Global Governance be effective if regulatory agencies are starved of resources? Regulatory agencies need to have the resources required for information gathering.126 As Eichengreen has remarked: “The problem of bloodhounds and greyhounds is a perennial: the greyhounds (financial market participants) run very fast while the bloodhounds (their regulators) struggle to stay on the trail. But a starvation diet does not help the bloodhounds keep pace.”127
The Basel Process was not intended for the non-G10 economies. In fact, it may not be the best method for pursuing bank supervision in emerging markets. As Barth, Caprio and Levine conclude in their analysis of banking supervision in over 150 countries, “…the analyses do not bolster the public interest view of bank regulation and supervision. Rather, official supervisory is associated with greater corruption in lending – a prediction of the private interest view”.129

Cornford points out that too rapid a change to the new banking practice of Basel II by emerging market economies would have adverse macroeconomic consequences. He observes that the fundamental assumption is that the relationship between a bank and its counterparties is not conducted at arms-length. Instead, a different model of borrower-lender relations exists involving practices such as policy or directed lending, relationship or name lending, and collateral-based lending. “In this model, loans are made on the basis of criteria different from those underlying Basel II, often resembling equity investments.”130

As Daniel Hardy notes in his study of banking in the developing world, regulatory capture naturally occurs because banking is one of the highest paid positions in which the knowledge of regulators makes them prime candidates to become bank managers. This tends to dampen friction between bank managers and regulators. Furthermore, regulatory capture by banks may even promote financial stability and the overall welfare of the state.131
3.2.9.3. Is Basel II “The Perfect Example of Regulatory Capture”?

Drezner has described the process of creating and enforcing global financial regulation as following a “club standards model of global governance” involving the club international governmental organizations (IGOs) like the Basel Committee, the Financial Stability Forum. These “clubs” enabled the G7 to bypass the Bretton Woods institutions (the International Monetary Fund and World Bank) and thus create a much more closed and opaque decisionmaking body. As a result, the “Basel process” has suffered from a “democratic deficit” whereby the vast majority of countries observing the Basel accord were excluded from the decisionmaking process. Of course, non-governmental organizations and transnational social movements have been excluded. Tsingou criticizes Basel II much more harshly as: “the perfect example of regulatory and supervisory capture: it benefits big players, does not include tough regulation and its complex approaches are a clear market entry barrier…. The move to more market-oriented and more transnational forms of governance [has] resulted in a process of capture by private interests of the crucial public policy functions of regulation and supervision”.133

The three most prominent private actors in the literature on the Basel Process were the G30, the International Swaps and Derivatives Association, the Institute for International Finance. They are prime examples of self-regulatory bodies within networks of private authority critical to understanding the Basel Process from a Global Governance perspective. The G30 and the Institute of International Finance were instrumental in proposing that Basel I be overhauled to allow for more breakdown, or “granularity”, of categories of risk. In Rosenau’s terminology, this assemblage of experts is a “sphere of authority”.134
Investments created by governments are not all equally risky or “riskless.” Securities issued by the United States are considered so safe that their rate of interest is referred to in finance literature as “the risk-free rate.” Investment securities issued by “emerging market” economies are considered riskier due to the underlying economic performance and political stability of the issuing government; the adherence to generally accepted accounting policies; and the stability of the state’s currency. While government bonds are considered riskless (requiring 0% capital backing), sovereign debt crises (such as recent crisis in the EU zone) show that they are not always safe and liquid.135

Banks may also invest their funds in the securities issued by corporations. The riskiness of every corporate security reflects the cash flow of the corporation and probability that the corporation will default on its financial obligations. In the American system, external credit rating agencies assign corporate securities a grade that is supposed to reflect the risk assumed by the buyer of the security.

The differentiation of credit risks was an issue with ISDA (The International Swaps and Derivatives Association, Inc) and the IIF (Institute of International Finance), which called for more breakdown, or granularity, of categories. Banks argued that their internal credit rating methods were more reliable and used more advanced methodologies than those of the external credit rating agencies. The differentiation of credit risks was also an issue with ISDA and the IIF that called for more breakdown, or “granularity”, of categories. There are two aspects of their involvement in the Basel Process to be discussed, their role in the regulation of new financial instruments and their role in the movement to drastically revise the Basel I Accord.
Private market participants have acquired a rule-making role and have influenced the policies and institutions governing global finance such as the Basel Accords. While the IIF represented the interests of its members (the largest international banks), the emerging market economies were not included or consulted about proposals that directly affect their interests as, for example, the availability of trade financing to support their critical export activities. This relationship between the Basel Committee and the IIF thus facilitated “the successful translation of IIF preferences into committee policy”. 136

Analysts from the Public Choice perspective focus on whether the influence of private-sector actors has improved the efficiency of policies or promoted market stability. Proponents of enhanced private-sector involvement see them as essential to enabling public authorities to provide the public goods of market regulation and crisis management.137

These three institutions are complemented by what Seabrooke and Tsingou call the three “professional ecologies.” Tsingou’s research expands to include the role of the G30 and the long history of the “revolving door” between the public, private, and academic sectors. Seabrooke and Tsingou identify three “professional ecologies”: “Fiscal and Monetary Systems (FMS), those concerned with public finance and monetary policy; Asset Trading and Evaluation” (ATE), banks and investment firms, as well as risk management and credit rating; and “Professional Economic Sciences (PES), those engaged in the professional development of economic theories.”138

The most influential among the US academic and expert opinion community is the Shadow Financial Regulatory Committee which is self-described as “a group of publicly
recognized, independent experts on the financial services industry who meet regularly to study and critique regulatory policies affecting this sector of the economy”.

The G30, a think-tank consisting of high-level private sector representatives, public officials, and academics, played an important role in promoting a consensus among experts that a revision of Basel I was necessary. The G30 perspective was strongly shared by the Federal Reserve Bank of New York that was advocating the same position.139

The continual interaction between the public and private sectors (“elite interaction” through training and socialization) through the “revolving door” in global finance fosters cohesiveness in the “preferences, priorities and goals” of the governance network and “expectations on what is feasible, acceptable and desirable in the regulation and supervision of global finance.”140 This argument applies to financial regulatory systems in general and is therefore an argument in favor of the libertarian belief that all government regulation merely fosters an atmosphere in which “morally hazardous” behavior is encouraged, leading eventually to the very disasters that they are intended to prevent.

3.2.9.4. Basel, the Democratic Deficit and the Governance of Global Finance

Global Governance is also concerned with the study of the public sphere (the global “public commons” as Germain calls it) in the governance of the global financial system.141 The Basel Process occurred, to some extent, in cyberspace allowing for participation by the rapidly expanding universe of NGOs whose transnational activism has given rise to the notion of “global civil society.”142
The BIS is also the “hub” around which central banks organize and channel their own research, so that the research of its member nations becomes accessible to all interested.¹⁴³ While the BIS provides research for central banks, its economists produce research that is depoliticized in its language and perspectives. Major contrasts financial economists and statisticians who were “ultimately severely constrained in their ability to provide a broader perspective on questions of global financial market stability” with those analysts who understood the “deeper, systemic problems of political economy”.¹⁴⁴

Financial crises are dealt with as economic, not political, problems, and the debate centers on the proper economic response. Of course, economic theories are not value-free or ideologically neutral. As Andersson implies, although does not explicitly state, the research produced by the BIS is embedded in the post-Washington consensus of neoliberal globalism.¹⁴⁵

Communications between central banks and financial regulators are normally private.¹⁴⁶ The participants in the Basel Process speak the specialized jargon of central banking and bank supervision that allow the participants to “shun the limelight.” The use of jargon among specialists on international financial regulations like central bankers helps to maintain the insularity of the debate over the Basel Accords.

The Basel Committee issues “consultative papers” in order to elicit responses to proposed regulatory changes. It sought to increase the transparency of the overall consultative process (including four rounds of proposals and responses in the 1999-2004 period) by posting the proposals and policy responses from the industry and other regulators on the
website of the BIS. The Basel Committee therefore displays sensitivity to its lack of legal standing and seeks to reduce perceptions of its secretiveness.

However, given the esoteric nature of the discussion over definitions of capital and proper techniques for banking supervision, it is not surprising that the majority of comments came from private sector institutions and that there was very little participation from outside the banking industry. In his study of the debate on the Basel II proposals, Major found that 78% of the responses came from private banking and financial firms. This is often regarded as proof of regulatory capture at work since the discussion is almost entirely between the regulators (central banks) and the regulated (financial industry). Here is a typical notice to the industry that its complaints have been heard and will be acted upon: “Regulators have promised to give careful consideration to these comments… Chairman Wellink has also indicated that the Committee will look closely at the industry’s complaints about proposals to exclude tax-deferred assets and minority interests from the calculation of banks’ Tier 1 capital.”

Discussions of financial risks, while done in full public view on the website of the Basel Committee, are unintelligible to the “attentive” public. By quantifying risk assessments, financial regulation escapes the intellectual grasp of the public since it requires technical and expert knowledge.

To Underhill and Zhang, communicating in the opaque jargon employed in central banking and international financial supervision allows the regulators and regulated to discuss issues in the public interest while also maximizing the profitability strictly for the benefit of this private industry. The use of such jargon is make “the Basel Committee
appear to deliberate in Olympian detachment,” thus disguising the fact that it has more in common with the “small community of private interests… than with other sectors of the economy and society”.154

Even with expert knowledge, it is easy to be mislead about the depth of disagreements in the comments: “…it is normal for regulators to propose more than they expect to get, allowing those regulated to feel their concerns were at least partly heeded.”155

The main participants were the banks and the authorities responsible for regulating them. A parallel debate took place between the regulators themselves in the different countries involved as they tried to advance the interests of the banks in their respective jurisdictions. A third debate developed among academics and the financial press as the potential consequences of a re-worked capital accord came into focus.156

How can the Basel Process become an effective regime for the governance of global finance if dozens of affected countries have no mechanism for participating in the global deliberations? The Basel Committee recently established the International Liaison Group (ILG) to provide a forum for deepening its engagement with supervisors around the world on a broad range of issues. It provides a platform for non-member countries to contribute to new Committee initiatives early in the process and to develop new proposals that are of particular interest to ILG members.157 Further research is required to determine the nature and extent of these consultations.
3.2.10. Moral Hazards and the Libertarian Critique of Global Governance

A “free market” libertarian would say that the advancement of Private Interests is what allows the Invisible Hand of the marketplace to operate successfully and that “free market fundamentalism” will always achieve the greatest good for the greatest number.158

Incentive for banks to get increasingly involved in more risky operations was provided by the availability of two safety nets: on the one hand, a generous deposit insurance system to prevent a bank run; on the other hand, the central bank as a lender of last resort to prevent the default of banks.159 These safety nets have led to moral hazard problems.160

The Global Financial Crisis has further shaken faith in the Basel II framework’s heavy reliance upon internal models and ratings agencies – even, perhaps, for true believers such as Alan Greenspan. It has also left the US banking system – and that of many other countries – seriously under-capitalized in ways that were never predicted by most proponents of models-based regulation. The provisions in Basel II for potentially reducing further the amount capital held by large and small banks and lowering the risk-weighting for residential mortgages have proved sorely inadequate. The Obama administration’s recent appointment of Daniel Tarullo, a Basel II critic, to the Fed’s Board of Governors highlighted growing sentiment for a major overhaul of Basel II.

Because of the GFC, public attention to the arcane subject of global financial regulation and the role of key institutions such as the Federal Reserve has increased dramatically. The public has input into the policymaking process through its representatives in the legislature. Some of these legislators are extreme libertarians. For example, the new Chairman of the United States House Financial Services Subcommittee on Domestic
Monetary Policy and Technology, Ron Paul, is a leading advocate of abolishing the central bank of the United States.
Human affairs are largely governed, that is, “ruled” on a day-to-day basis, not only by states, but also by a multitude of individual polities that exist within, crisscross, or transcend individual states... This is the “real world order.” 161

Basel I, with only 12 members at the time, took less than a year to hammer out as an agreement. It was adopted by more than 120 nations. Basel II, by contrast, was championed by banks, which argued that a more modern approach to risk management had emerged and needed to become the basis for capital regulation. Blom contrasts the negotiations leading to Basel I with those leading to Basel II. The renegotiations had a much higher degree of international consensus on the need to be more comprehensive about bank risks. The first set of negotiations started as bilateral negotiations while in the second set the Basel Committee became firmly entrenched in global level policymaking involving the participation of the transnational policy community.162

This section introduces the “dramatis personae” in describing the political sociology of the Basel Process.163 The participants can be categorized as belonging to the public or private sectors. A third category, “mixed,” has been added to highlight the constantly revolving door between public and private sector participants and to highlight the one key institution in the development and implementation of the Basel Accords, the Federal Reserve Bank of New York.
## 4.1. Matrix of Participants in the Basel Process

<table>
<thead>
<tr>
<th></th>
<th>Public</th>
<th>Private</th>
<th>Mixed</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Supranational</strong></td>
<td>G10, G20, G77, European Union, BIS, BCBS, Basel Senior Supervisors Group, Financial Stability Board, IMF, World Bank, IOSCO, IASB, FASB</td>
<td>“Core banks”, the financial markets, hedge funds, “financial engineers”, financial risk analysts, credit rating agencies, mass media</td>
<td>Banks and investment firms; risk management and credit rating agencies and professional economists. The G30 and IIF</td>
</tr>
<tr>
<td><strong>National</strong></td>
<td>Executive branch, finance ministries, central banks, financial regulators, legislatures and subcommittees,</td>
<td>Large national banks and corporations, pension funds, insurance industry, industry associations and lobbyists</td>
<td>Federal Reserve Bank of New York, “Government-Sponsored Enterprises”</td>
</tr>
<tr>
<td><strong>Subnational</strong></td>
<td>State banking supervisors</td>
<td>Community banks, private citizens</td>
<td></td>
</tr>
</tbody>
</table>

Basel is an example of multilevel governance. It involves supranational institutions (Bank for International Settlements, the Basel Committee), central banks, finance ministries,
multiple overlapping financial regulators, industry lobbyists, legislative bodies with oversight powers, transnational governance structures (regulators working across state boundaries to develop new regulations), and transnational interest groups.\textsuperscript{164}

The Bank of International Settlements (BIS) was established by central banks in 1930 in Basel, Switzerland as “the central bankers’ central bank”.\textsuperscript{165} It was initially intended to serve as a clearinghouse of information shared between central banks overseeing the repayment of Germany’s reparations from World War I.\textsuperscript{166} Since then, the BIS has grown into the institutional setting in which central bankers can address issues of concern to their individual economies and the global economy.

The Basel Committee on Banking Supervision (“Basel Committee” or BCBS), comprised of twenty-seven countries, conducts its work under the review of its oversight body, the Group of Central Bank Governors and Heads of Supervision of its member jurisdictions.\textsuperscript{167} The Financial Stability Board also works closely with the Committee.

The dominant function of modern independent central banks is to control the national money supply. Whether central banks should simultaneously act as regulators of their local banking systems is not a universally agreed function. Felsenfeld surveyed thirty countries and concluded that twenty \textit{do not} give their central banks regulatory responsibilities.\textsuperscript{168} The central bank of the United States does regulate a major share of the American financial system including national banks and all bank holding companies. England has gone the other way with the Central Bank of England performing regulatory functions until they were taken away in 1997 and given to the newly formed Securities and Investment Board (now Financial Services Authority).\textsuperscript{169}
Debate over the independence of central banks has not been settled, although independent central banks have spread around the globe. When economic conditions become dire, the power of the central bank increases as the need to “rescue” the economy increases and the central bank steps into the role envisioned as the “lender of last resort.” Indeed the Global Financial Crisis has shown the extent to which the Fed has the authority to act as “lender of last resort” not only to commercial banks but to investment banks, insurance companies, and other businesses under a provision of a 1932 federal law concerning “unusual and exigent circumstances”.170

4.2. International Negotiations on the Definition of Capital and Capital Adequacy

Basel I focused on credit risk (the most frequent cause of bank failures) by establishing four “risk buckets” based largely on the identity of the borrower. The minimum ratio of capital to assets (capital adequacy) was set originally at eight percent as sought by the Anglo-American regulators. German banks typically operated with much higher ratios. The Japanese banks were required to reduce assets in order to comply.171 Thus, Basel I was based on a compromise on how to measure capital adequacy that satisfied the liberal Japanese and the conservative German positions.

This bilateral agreement incorporated the risk-weighted approach and a two-tier capital structure. The latter means that there was base primary capital (stocks, retained earnings, general reserves, and some other items) and a second tier of limited primary capital, including for example some types of subordinated debt. The second tier capital could not exceed half of total base capital in counting towards the capital adequacy ratio.
Britain, France, and Belgium did already use more sophisticated “risk-weighted” capital adequacy standards. The Bank of England had developed these capital adequacy measures in response to their “fringe banking” crisis of 1973. While the United States used a fixed-weighting system, the Europeans used a variable method and the British used a method close to the Europeans. US FDIC Chairman William Seidman supported the shift towards the British system of risk-weighted capital standard. Thus the first Basel Accord was a product of negotiations between only two states, the US and Britain, with the US agreeing to accept the British approach to banking supervision rather than the other way around.

4.2.1. The Basel Process and the American “Dual Banking System”

There are four regulatory agencies for banking in the US: the central bank (Federal Reserve), the Office of Thrift Supervision, the US Treasury Department’s Office of Controller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). These agencies interact with a number of relevant state banking authorities and the Conference of State Bank Supervisors. Each of these regulatory institutions specializes in a different type of bank, creating a “dual banking system.” Focusing on large banks would leave small banks at a competitive disadvantage. If there were only one regulator, it would be more likely to be captured by the banks it regulates.

The Federal Reserve Board and Federal Reserve Bank of New York (lead negotiator for the United States) promote the interests of large international banks rather than small community banks. The special clientele of the Comptroller of the Currency is “money-center” and regional banks. The Office of Thrift Supervision supports the mortgage
market and building industry. One can see how the Fed and OCC would have more in common with each other, often bringing them into conflict with the FDIC and OTS. The FDIC, seen as representing the interests of the community banks, objected that Basel II would give the larger banks a break on capital requirements and put smaller institutions at a competitive disadvantage.173

Another actor is the Securities and Exchange Commission, the regulator of many of the institutions comprising the “shadow banking system”. As the recent financial crisis revealed, the failure to include these institutions in the Basel Accords was a fatal flaw in its design. Although they are not technically banks, they do rely on very short-term financing, thus leaving them every day 24 hours away from a liquidity crisis.

Ample lobbying opportunities allowed banks to play off one regulator against another. Not surprisingly, given their constituencies, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) opposed the internal model-based approach to capital calculation. Among the numerous financial lobbyists are the Independent Community Bankers of America, American Securitization Forum, Financial Services Roundtable, Risk Management Association, and the American Bankers Association. The most influential among the US academic and expert opinion community is the Shadow Financial Regulatory Committee.

Since the Basel Process is a case study in the making of international soft law, the negotiations within nations between the “agents” (the bureaucracy and the regulators) and the “principals” (the legislative branch) that oversees the regulators will be our primary focus. What are the costs and benefits of further cementing political ties between the
financial industry, the financial regulators, and the financial committees of the US Congress? Has regulatory capture shaped the detailed legislation to the advantage of the banks and the disadvantage of the public? Does the need for long-running negotiations ensure that bargaining coalitions can only be held together by an endless stream of side-payments to ensure continued support during the arduous process of drafting regulations, running parallel “quantitative impact studies,” and eventually implementing the regulations.

As recently as 2007, US authorities also announced that they would extend the agreed implementation deadline for another year to allow banks more time to make necessary changes, plus an additional three year transition period during which the regulators could apply limits on the amount by which required capital could decline under the Basel II framework. As Herring observed, the domestic Basel II coalition was in danger of unraveling.174

4.2.1.1. Role of the Federal Reserve Bank of New York

“The very fact that certain entities submitted comments raised interesting questions. For example, the Federal Reserve Banks of Chicago and Richmond both sent letters to the Basel Committee, giving rise to the inference that the Board of Governors and the Federal Reserve Bank of New York had not fully involved the rest of the Federal Reserve System in developing their Basel Committee positions.”175

The Federal Reserve Bank of New York is structured as a “mixed public-private sector institution.” Not only do central banks differ according to their inherent powers, but also whether they are more responsive to public or private interests. The structure of the Federal Reserve System was a political compromise between those who wanted a strong
central bank and those who wanted a decentralized system where the centers of authority were closer to the businesses and markets throughout the US.

Twelve regional banks were established in twelve Federal Reserve districts. Although fully part of the Federal Reserve System, the district banks were constituted by the local banks in their respective districts with Boards of Directors appointed by those shareholding banks. The “New York Fed” was the largest regional bank in the FRS because New York was the center of the money market in the United States. It therefore had the largest proportion of capital among all of the other district banks and the greatest responsibility for regulating the American financial system.

The Federal Reserve Bank of New York is unique in that, among all central banks, it can be described as contributing to the maintenance of the International Financial Architecture: the provision of liquidity, the management of the process of internal and external adjustment, the provision of stability, and the fostering of economic competitiveness.176

The first feature of financial architecture in which the Federal Reserve Bank of New York plays a role is provision of liquidity to the domestic economy to ensure that the growth of money and credit supports the economic growth of business and households. From its founding this was the most important function of the system. Over time, the Fed acquired a “dual mandate” to contribute to the attainment of the highest level of employment possible (as mandated by the Employment Act of 1946 and 1978 Full Employment and Balanced Growth Act) while at the same time protecting the value of the currency from inflation domestically and excessive depreciation internationally.
International reserve assets are vital to support the expanding volume of international trade. Other countries need unconditional access to central banks that issue international reserve assets, that is, international money or financial assets acceptable for the settlement of international imbalances. The Federal Reserve Bank of New York is involved in the provision of international reserves through “swap” or short-term credit networks between central banks.\textsuperscript{177}

Adjustment refers to the balancing of a state’s external balance of payments. It involves the regulation of international capital flows and the use of exchange rate policies to influence the balance between exports and imports. Although the regulation of international capital flows and intervention in foreign exchange markets are used only as a “last resort” in international financial crises, the Federal Reserve Bank of New York plays this role in the Federal Reserve System.

In addition to the provision of domestic and international liquidity and adjustment, the Federal Reserve Bank of New York is deeply involved in the provision of stability in times of financial crisis. As the “lender of last resort,” the Federal Reserve Bank of New York provides emergency funding to banks via the discount window to prevent financial crises. The Federal Reserve Bank of New York not only plays a role in the management of financial crises but also in the prevention of crises through the more mundane business of regulation and supervision, shared with Comptroller of the Currency and state banking authorities). As an auditor, the Federal Reserve Bank of New York requires documentary evidence of adherence to controls that affect a bank’s ability to operate at all.
What was the impact of the BCCI scandal in 1991 on the new Basel Accord? How did the FDIC Improvement Act of 1991 complement the new Basel Accord? How did the Foreign Bank Supervision Enhancement Act of 1991 strengthen the implementation of Basel I? The role of the Federal Reserve Bank of New York will be discussed in the following chapter highlighting its role in championing Basel II in the 1990’s.

4.2.2. Germany and the Conservative End of the Spectrum

As Daniel Tarullo reports, it took over a decade for supervisors to thrash out agreement with countries like Germany who fought to preserve the use of hybrid capital. German bank regulators insisted that only retained profits and paid-in shareholder funds ought to count as regulatory capital. At the other end of the spectrum was West Germany, the bastion of financial conservatism. The experience of the hyperinflation of the early 1920’s had very deeply embedded in the German psyche the absolute need for financial stability without which the society could collapse. To the Germans, capital consisted of fully paid-in capital that was certain to be available as a cushion in times of crisis. The German position stood in stark contrast to the much more liberal Japanese stance.

4.2.3. Japan and the Liberal End of the Spectrum

“The Basel Committee was well aware of the fiction of adequate capital maintained by Japanese banking supervisors in their prolonged and ultimately misguided efforts to muddle through the banking crisis rather than take aggressive corrective action”

“Few outside observers, much less other members of the Basel Committee, believed that Japanese banks were as well capitalized over the last decade as their reported ratios showed. As the Japanese banking crisis worsened and the Japanese economy stagnated, this forbearance looked progressively less like an effort to gain international competitive advantage and more like regulatory paralysis”.
The most fundamental issue of an agreement to harmonize regulatory capital requirements in the banking sector is “what is capital?” How can international regulations on capital adequacy be harmonized if there is no agreement on the definition of capital itself? For example, before Basel I was negotiated, Japan’s regulatory goal “involved a simple capital/assets ratio, whose value varied from 4 percent for banks without overseas branches to 6 percent for banks that did have an international presence.”

In the politics of the Basel Process, the Japanese have consistently taken one of the most liberal positions on the definition of regulatory capital. The Japanese apparently could not easily agree to the harmonization of international capital standards because their banks were carrying so many bad loans. The Japanese Ministry of Finance therefore allowed a much looser definition of what is capital to included unrealized profit on securities. As Reinecke notes, unrealized profits evaporated when the Japanese stock market collapsed in 1989. Thus, part of the Japanese attitude towards capital adequacy regulations is attributable to the desperate state of the Japanese banking industry that left many bad corporate loans on the bank balance sheet instead of being written off. Notably, Japan chose to shoulder the burden of the bad debts of the domestic financial sector by changing the tax code to allow for deduction of a portion of the loan losses. The American approach, on the other hand, implicitly meant promoting IMF funding of the debt-laden emerging markets to ensure the American banks loans were eventually repaid.

The Japanese concept was so loose that they allowed banks to count unrealized profits and capital invested in by related insurance or other types of corporations in a bank’s
capital structure. The Japanese have an interlocking system between banks and insurance companies, in which insurance companies bought debt from the banks, a practice known as “double gearing.” In effect, the same capital was used as a buffer against risk in two or more legal entities. “Tarullo summarizes: “the banks lent money to the insurance companies so that the insurance companies could buy subordinated debt from the banks… in order to increase tier 2 capital”. 184 “Double-gearing” is considered unacceptable to the Basel Committee.

The Japanese also argued that their unrealized profits should be counted as capital insofar as Japanese banks were allowed to count unrealized profits from holdings of equities and real estate as capital. This source of capital was severely depleted after the Japanese bubble burst in the late 1980’s. As Blom reports, the Japanese initially sought to have these unrealized gains as 70 percent of capital requirements, as was already domestic practice. The US and especially the UK objected, since their banks were not allowed this practice due to domestic accounting rules. This issue was so important for the Japanese banking sector that their association even petitioned to the US Fed directly on this issue. The negotiation resulted in a 4 percent weight as capital. 185

Japan also fought the hardest against the elimination of deferred tax assets, past losses that lenders use to offset tax charges in future years. 186 Japan does not limit the use of these credits in the calculation of regulatory capital even when there is little chance of profits against which these credits can be taken during the five years until the tax deferred tax assets expire. 187 The Japanese banks also attempted to count the value of their internal software towards their levels of capital. 188

“The United States continues to influence the Basel process but, in effect, treats the guidelines as optional,” Andrew Procter, the bank’s head of government and regulatory affairs, wrote to the [Basel] committee. “Deutsche Bank believes that no other Basel committee members should move ahead with implementation until there is a clear timetable from the U.S.”

“Basel I was built around a standard formula for calculating banks’ capital ratios, relative to their risk-weighted assets. It is nothing short of ironic that an inability to close the deal on Basel II in the United States is based on a growing perception of similar global threats to domestic [American] banks“.

5.1. Basel as an Iterative Process

Given the sheer number of transactions and types of financial products, writing rules for financial markets is very difficult and challenging even to those who are experienced and knowledgeable. Not surprisingly then, financial regulation occurs at a “glacial pace.”

One fascinating feature of the process by which the Basel Accords have evolved is that there has been constant give-and-take between the governmental authorities (the regulators) and the financial industry (the regulated).

The Basel Process has an “iterative nature” which can be grouped in three categories. Kane describes the Basel Process as having an iterative quality composed of “alternating sequences of action and reaction: (1) Regulation-Avoidance Sequences and (2) Avoidance-Reregulation Sequences.” Kane’s analysis can be applied to the Basel Process with these phases:

1. The Basel Committee announces a policy
2. The financial industry has a chance to digest and evaluate the impact of the policy on their interests

3. The industry makes counter-proposals to the BCBS

4. The Basel Committee evaluates those counter-proposals and reissues its policy again

The global effort to do this has produced “Basel burnout” within Congress and the financial industry. Central bankers, banking supervisors and other financial regulators will continue to pursue the negotiating approaches adopted for Basel I and II simply because too much time, effort, reputations and other “sunk costs” have been invested in it.

5.2. Phases of the Negotiation Process

According to Berridge, the negotiation process can be broken down into the following phases: negotiations over what is to be negotiated (the “prenegotiations”); “around the table” negotiations (to the extent that they have been publicized); keeping the diplomatic (and legislative) momentum going; packaging the final product; and (the most crucial stage) following up on the implementation of the agreement.193 The Basel Accords are the result of international negotiations but do not easily fit into such neat categories.194

Since this is an exercise in international “soft law”, there is no ratification process, although there have been lengthy congressional hearings on the subject in the United States. National regulators are also permitted a long list of exceptions to full implementation, known as “supervisory discretion” within each banking system. Furthermore, political leaders and banking regulators may actively oppose these
regulations. All of this contributes to a situation in which agreements are inconsistently adopted among all of the countries that claim to adhere to the regulations.

5.2.1. The Road to Basel I

The Basel Process was initiated as an effort at crisis prevention, not simply crisis management. “If things really get bad, we cannot expect the banks to withstand the crisis without a lot of central bank help. The goal of regulators must be to keep it from getting to that point.” The Basel Accords include not only the “harmonization” of capital adequacy standards but also resolving the jurisdiction of host vs. home country supervision over foreign bank branches and the establishment of a global set of “best practices”.

In terms of Global Governance, there is a striking parallel between the 1944 agreement governing the international monetary system and establishment of international financial institutions and Basel I, in that both emerged from a set of bilateral negotiations between the US and Britain. In the planning for the post-war international economy, the United States and Britain were represented by Harry Dexter White and John Maynard Keynes, respectively. They agreed that a new international economy would have to build on an implicit compact supported by the broadest strata of society that would protect the ability of individual countries to pursue reconstruction and development goals regardless of external imbalances.

Under the Bretton Woods Agreement of 1944, countries were to be allowed the maximum freedom to pursue the post-war reconstruction projects while restricting the free flow of capital (“hot money”) across borders in search of higher yielding
This mix of policies was intended to give the countries recovering from the Second World War maximum freedom to pursue development goals while shielding them from the ravages of international capital movements that could easily undermine such goals.

The European Payments Union clearinghouse carefully controlled the international monetary system throughout the 1950’s. As those controls on capital were relaxed at the end of that decade, foreign investments spread and capital markets grew. This gave rise to fears of a “dollar overhang” which could undermine the stability of the international financial system. Throughout the 1960’s, the industrialized nations pursued efforts to maintain the Bretton Woods system.

5.2.1.1. The Need for Basel I: Stability or Competitiveness?

There are two schools of thought on the need for the Basel Accords. Either the US regulatory authorities sought to contribute to international financial stability, or the authorities attempted to gain important competitive advantages for their banks.

The Basel Process commenced in the 1970’s in response to the progressive relaxation of national controls of the flow of international capital. Once the controls on the international flow of capital were essentially abandoned and the exchange rate system converted from a fixed to a floating regime, the crises of the international banking system became a regular feature of the international financial system in the 1970’s. After the collapse of Bankhaus Herstatt in 1974, the governors of the Group of Ten established the Standing Committee on Banking Regulations and Supervisory Practices comprised of representatives of the supervisory authorities and central banks of the Group of Ten
countries plus Switzerland and Luxembourg. The official name of the committee was subsequently shortened to “The Basel Committee on Banking Supervision,” but for brevity, it is usually referred to as the Basel Committee. The Committee's first agreement on bank supervision was the Concordat of 1975.

Stagnation and high inflation in the US economy were compounded by the “oil shocks” in 1973 and 1979. The steady weakening of the US Dollar convinced Federal Reserve Chairman Paul Volcker to implement a policy of monetary targeting which drove interest rates to astronomical levels. This resulted in the cooling of inflation but also drew capital flows into the United States contributing to the “LDC Debt Crisis”.

In 1980, the Offshore Group of Banking Supervisors was formed once agreement on a common standard for capital adequacy was reached in the United States between the Federal Reserve Bank, the FDIC, and the Office of the Controller of the Currency.

In May 1984, Continental Illinois required $6 billion infusion to meet immediate financial obligations due to its highly leveraged and risky investment portfolio. After the collapse of Continental Illinois, an agreement (Basel I) was negotiated between the Federal Reserve, the Bank of England, and the Bank of Japan that resulted in the standardization of capital requirements for all global banks in G10 countries. Progress was made during 1984 with regard to cross-national comparisons of capital levels in the Basel Committee. They devised a “framework” which enabled central bankers to compare their national methodologies, taking into account different definitions of capital and varying methods for calculating capital-to-asset ratios.
Ethan Kapstein (the “inside source” on Basel I) explains that Basel I was part of a comprehensive approach to ensuring stability in the banking sector. This approach involved negotiations on assets and on liabilities on banking balance sheets. On the asset side, the Federal Reserve would place greater emphasis on loan quality in the banks it examined. On the liability side, the new Basel capital adequacy standards established and increased capital levels in banks where regulators felt this was necessary. These negotiations involved a small group of supervisors at the Federal Reserve Board in Washington and the Federal Reserve Bank of New York who explored the regulations that were in place in other countries, particularly within Western Europe.

Volcker suggested that a bilateral agreement on capital adequacy be negotiated with the Bank of England since the US and UK employed the same methodology for determining capital adequacy. At the same time, Brian Quinn acted as envoy to the European regulators while Gerald Corrigan, President of the Federal Reserve Bank of New York, traveled to Tokyo to negotiate with Japanese officials. International efforts to harmonize banking supervision were initiated by the United States in the bilateral negotiations with Britain leading to Basel I. The European Community started in 1973 to integrate European markets culminating in the adoption of the First Banking Coordination Directive in 1977 by the European Council. However, as Blom notes, there was no mention of a specific target ratio or of the ratios being risk-weighted. Curiously, though, when Paul Volcker talked to Basel Committee regulators in spring 1984 about the need for harmonized bank capital standards, he was greeted with a “big yawn.”

Industrial nations responded to the challenges posed by financial globalization by promoting international cooperation based on home country control meaning that the
responsibility for regulating national financial institutions resided with the state in which the institution maintained its headquarters rather than its branches. As Cooper put it, the Basel Accords were initially a response to the mismatch between the domain (the geographical area over which financial institutions and markets operate) and jurisdiction (the machinery of legislation and regulation that ensures the orderly operation of markets) of international finance.

As Kapstein notes, the bilateral agreement established between the two nations in 1987 threatened to create a “zone of exclusion” that was disadvantageous to other international banks in other countries. It therefore hastened the general acceptance of the need to accept these kinds of regulations. The 1987 agreement between the United States and Britain encouraged the Japanese supervisor to continue working on a capital standard, especially since the threat of exclusion apparently materialized. The compromise on the 8 percent level was below German standards and above Japanese standards. As Blom notes, the banking licenses for several Japanese banks wanting to enter the American market were postponed adding to the pressure by American and British policymakers to get Japanese supervisors to support the discussions leading to Basel I.

5.2.1.2. Basel I and Leveling the Playing Field: The Japanese Challenge

The previous discussion argues for the view that Basel I was necessitated by the need to provide some financial stability for the global banking system. There is another school of thought on this, that the threat of Japan was the main concern of the international banking market.
The Japanese system is noted for its distinctively “corporatist” characteristics reflecting the alliance between government and industry (“Japan, Inc.”). This featured the keiretsu relationship between banks and industrial concerns that guaranteed that Japanese banks would be favored for financing; implicit guarantees from the tight safety net provided by the Bank of Japan; and high domestic savings rate which made capital cheaper.

It is not surprising that a country that was pooling the combined power of business, labor, education, and government to achieve astounding rates of growth after World War II advocated such a liberal definition. While financial regulators saw an urgent need for a policy response, the competitive advantage of Japanese international banks dominated the policy response in the United States and Britain in the early 1980’s. The growth of Japanese assets reached an astonishing pace in the 1980’s. Until 1981, only one of the 10 largest banks in the world was Japanese. By 1988, however, nine of the 10 largest banks in the world were Japanese while the proportion of the assets went from a quarter of the world’s largest banks to 70 percent. As Wagster notes, in 1981 only one of the ten largest banks in terms of total assets was Japanese. By 1988, the seven largest were Japanese. It appears that by the end of the decade, Japanese banks had captured 38 percent of all international lending, including 12 percent of the U.S. banking market and 23 percent of the U.K. banking market.

US bankers and policymakers noted “the capital ratios of both Japanese and American banks had moved inversely to their market shares.” Japanese capital ratios declined from well over 3 percent to roughly 2 ½ percent, while the capital ratios of the largest US, French, British and German banks all increased during this period as their market shares
all fell. Central bankers thus entered multilateral negotiations with conflicting definitions of what constituted bank capital. As Kapstein notes, banks sought to gain competitive advantages by lowering their capital requirements. This is a constant theme throughout the entire history of the Basel process.218

5.2.2. Iteration: From Basel I to Basel II

The rationale for, and participants in, the renegotiation of Basel I was discussed in Chapter 3 under the heading “Controversies over Demands for Industry Self-Regulation”.

How did the Federal Reserve Bank of New York facilitate the long-dormant linkage between the US and the Bank for International Settlements?219 Gerald Corrigan, President of the Federal Reserve Bank of New York President served as chairman of Basel Committee from 1991 to 1993. However, no American official served as a director or alternate director of the Bank for International Settlements until 1994 when the Federal Reserve Bank quietly announced its intention to occupy the two seats on the Board of Directors to which the United States had been entitled since 1930. Alan Greenspan became an ex-officio member of the Board of Directors of the Bank in September 1994 when William J. McDonough (President of the Federal Reserve Bank of New York) also joined the Board for a three-year term.

As Felsenfeld and Bilali note, the fact that the Federal Reserve Bank formally joined the BIS went almost unnoticed in the U.S. banking and financial community, with the exception of a few dozen U.S. banking experts. There were no U.S. Congressional hearings nor was there any public statement by the U.S. President or the Secretary of State. Almost a year later, the New York Times reported that the Federal Reserve Bank
had joined the BIS, which was, interestingly enough, characterized as an “obscure global bank [that] moves into the light.”

The momentum for change in the Basel Accords strengthened when Federal Reserve Bank of New York President William McDonough succeeded de Swaan as chair of the Basel Committee in June 1998. In July, at the first meeting chaired by McDonough, the committee agreed to a thorough review of the Basel Accord. In September McDonough laid out the rationale and process for what he characterized as a “major effort” to revise the accord. The views of the largest U.S. banks were incorporated into drafts produced by the committee. Political leaders were not involved in the talks.

The Federal Reserve Bank of New York, Bank of England, Bank of Japan, and Board of Governors of the Federal Reserve hosted a conference in February 1998 on the limitations of Basel I. The agencies and invited academics explored alternative approaches to capital regulation, including the use of banks’ credit risk models as a basis for regulatory capital. Fed Chairman Greenspan made a very strong case for change, and throughout 1998, calls for change in Basel I became a regular theme in public statements of Federal Reserve officials concerning bank regulation.

The New Basel Accord (“Basel II”) consisted of three pillars: (1) minimum capital requirements, (2) supervisory review of an institution’s internal assessment process and capital adequacy, and (3) effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. Under Basel II, regulators attempted to encourage internationally active banks to use the more advanced methodologies to calculate risk-weightings: (1) the Standardized Approach (SA); (2) the Foundation Internal Ratings-
Based Approach (F-IRB); or (3) the Advanced Internal Ratings-Based Approach (A-IRB).

5.2.3. Iteration: Basel II Negotiated

The Basel Committee issued its first consultative paper in June 1999 (“CP1”). The proposal for a “Revised Capital Adequacy Framework” included: minimum capital requirements, which seek to refine the standardized rules set forth in Basel I; supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. The Basel Committee’s Capital Group evaluated a large amount of comments received on the second Consultative Package released in January 2001, a revised form of the 1999 package. CP1 encouraged improved risk management practices through capital incentives for banks to move to the more risk-sensitive IRB approach.

In April 2003, the Basel Committee released the new Basel Capital Accord for public comment. The next month the Basel Committee released the results of the third global quantitative impact study (QIS-3) and the third consultative paper. In August 2003, regulators released advance NPR on Basel II for comment. The proposed rule required the advanced approaches for credit and operational risk to be applied by only the large and/or internationally active banks and holding companies. Existing capital rules would be retained for all other banks.

5.2.4. Iteration: Basel II Accord Released

The issuance in June 2004 of the final revised framework for Basel II marked the start of a major iterative cycle in the Basel Process. The June 2004 framework included the
objectives of broadly maintaining the level of aggregate required capital; providing incentives to adopt the more advanced approaches; risk-sensitive minimum capital requirements; and the review of such assessments by supervisors and improvements in transparency in banks’ financial reporting.

According to Blount, the presence of banking leaders and lobbyists in Congress and their demands for a “redress of grievances” has grown steadily since the results of the third "field test" or Quantitative Impact Study (QIS 3) were announced in early 2003. The demands are normally based on their claims that federal regulators were ignoring the “competitive implications” of the proposed rules. In the case of QIS-3, federal regulators agreed to stage their own test that became known as QIS-4.226

By April 2005, however, the US regulatory authorities announced that they would delay the issuance of a formal notice of proposed rulemaking (NPR) concerning Basel II implementation while they awaited the results of a fourth round of quantitative testing of the new framework (the so-called QIS-4) due to concerns that Basel II might lead to excessive reductions in required capital. 227

QIS-4 revealed “unacceptable declines in required capital” leading regulators in September 2005 to announce a one year delay in implementation and additional safeguards. In October 2005, the small community banks which make up the vast majority of American banks, won a victory when regulators issued “Basel IA” providing a “more risk-sensitive framework similar to the standardized approach under Basel II.”228

The Federal Reserve released another draft Basel II in March 2006 to allow industry time to comment and prepare. It stated that a 10 percent or greater decline in aggregate risk-
based capital requirements (compared to Basel I) would warrant changes to the Basel II framework.229

In November 2007, the U.S. Department of the Treasury’s Office of the Comptroller of the Currency approved implementation of the advanced approaches of the Basel II Capital Accord.230 This approval included use of the Internal Ratings Based Approach (IRB) to measure credit risk, use of the Advanced Measurement Approach (AMA) to measure, enhanced standards for the supervisory review of capital adequacy, and public disclosures for the largest U.S. banks.

In 2008, the European Union implemented Basel II by incorporating it in the EU Capital Requirements Directives.

In July 2009, the Basel Committee released a final package of measures to enhance the three pillars of the Basel II framework. This included enhancements to the Basel II framework, revisions to the Basel II market-risk framework and guidelines for computing capital for incremental risk in the trading book.

5.2.5. Iteration: From Basel II to Basel III

Basel III is a consultative document entitled “Strengthening the Resilience of the Banking Sector” that was first promulgated on December 17, 2009, by the Basel Committee.231 This information has been concisely summarized by George Lekatis, president of the Basel II Professionals Association. The essential differences are shown below.232
<table>
<thead>
<tr>
<th>Tier 1 capital ratio</th>
<th>4%</th>
<th>6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core Tier 1 capital ratio</td>
<td>2%</td>
<td>-</td>
</tr>
<tr>
<td>- Before 2013 = 2%, January 2013 = 3.5%, January 2015 = 4.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 capital</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Capital Conservation Buffer | None | - |
| - Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7% |

| Countercyclical Capital Buffer | None | - |
| - Before 2016 = 0%, January 2016 = 0.625%, January 2017 = 1.25%, January 2018 = 1.875%, Jan 2019 = 2.5% |

| Capital for Systemically Important Banks | None | Under discussion |

5.2.5.1. Tier 1 Capital Ratio

There are two separate issues here. First, what is the definition of acceptable capital, and second, how much capital must a bank hold. In terms of the first issue, the quality of capital, the proposed rules would throw out whole asset classes that individual national banking industries depend on for a major part of their capital. For example, Jubak points out, Tier I capital would severely restrict “cross-shareholding” where banks own parts of each other. That proposal would hurt European banks that routinely own major shares in
each other. U.S. banks would also be impacted by the changes in Tier 1 capital that would require banks to maintain an amount of long-term loans and deposits equal to their financing needs for 12 months, including off-balance-sheet commitments and anticipated securitization. That would force many U.S. banks to move away from using the capital markets to raise funds and to increase their reliance on deposits.233

5.2.5.2. Capital Conservation Buffer
The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks would be allowed to draw on the buffer during periods of stress, the closer their regulatory capital approaches the minimum requirement, the greater the constraints on earnings distributions.

5.2.5.3. Countercyclical Capital Buffer
A countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. Banks that have a capital ratio that is less than 2.5% will face restrictions on payouts of dividends, share buybacks, and bonuses. The buffer will be phased in from January 2016 and will be fully effective in January 2019. The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth.

5.2.5.4. Total Regulatory Capital Ratio
In summary, the Total Regulatory Capital Ratio will consist of the following:
[Tier 1 Capital Ratio] + [Capital Conservation Buffer] + [Countercyclical Capital Buffer] + [Capital for Systemically Important Banks] \(^{234}\)

Further discussion of Basel III and its implications for the governance of global finance will resume in the concluding chapter.
Chapter 6: What Issues are on the Table? International Political Economy of Basel

Over the past six months business groups have found bashing regulations as anticompetitive to be a winning strategy, and it's not hard to find bankers -- or bank lobbyists -- willing to admit privately their hope that the Basel effort is about to implode.235

This chapter will discuss the international political economy issues encountered in the negotiations over Basel II.

6.1. Matrix of International Political Economy Issues

<table>
<thead>
<tr>
<th>BASEL II REQUIREMENTS</th>
<th>SPECIFIC ISSUES</th>
<th>PARTICIPATING STATES</th>
<th>ACTORS WITHIN EACH STATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basel II “Pillar 1”</td>
<td>Issue 1 + x</td>
<td>State 1 + y</td>
<td>Actor 1 + z</td>
</tr>
<tr>
<td>(capital adequacy)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basel II “Pillar 2”</td>
<td>Issue 1 + x</td>
<td>State 1 + y</td>
<td>Actor 1 + z</td>
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<tr>
<td>(Supervisory review)</td>
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<tr>
<td>Basel II “Pillar 3”</td>
<td>Issue 1 + x</td>
<td>State 1 + y</td>
<td>Actor 1 + z</td>
</tr>
<tr>
<td>(market discipline)</td>
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This “Matrix of International Political Economy Issues” helps students of the Basel Process to categorize the positions held by the numerous participants. In terms of Issues, if X ranges from 0 to 100, then each Issue x has its own category within the relevant
Pillar of Basel Accords. Within each Issue X, each nation (from \( Y = 0 \) to 100) has its own position. Drilling down further there is a separate position for each Actor (\( Z = 0 \) to 1000) within each Nation within each Issue. One can drill down further within each Actor.

6.2. Pillar 1: Capital Adequacy

6.2.1. Pillar 1: Capital Adequacy Issues over National Regulatory Styles

The most organized way to analyze the debate over capital adequacy is to examine the definition of the numerator of the capital ratio and then the denominator of the capital ratio. The numerator concerns “what qualifies as capital?” while the denominator concerns “compared to what assets”? Looking at Pillar 1 issues, there appear to be three major categories of structural disagreement: differential impact of capital due to the nature of the affected economy; differences in regulatory frameworks; and differences in risk profile of the banking systems.

Basel II specifies “Tier 1”, “Tier 2”, and “Tier 3” capital and the proper mix in a banks’ overall capital structure. Yet this has been a topic of continuing debate at the Basel Committee as witnessed by the fact that it maintains a permanent committee devoted to this single topic. Basel I defined two kinds of regulatory capital. Tier 1 consists mainly of shareholders equity, core capital including shares, and retained earnings. Tier 1 capital, a broader definition, includes hybrid capital instruments such as bonds that convert into equity when certain events occur. Tier 1 ratio is a measure of financial strength, which compares a bank’s capital to the exposure of its loans and other at-risk assets. Tier 1 capital is considered most stable and readily available for supporting a bank’s operations.
It covers core capital elements, such as common stockholder’s equity and noncumulative perpetual preferred stock. Tier 2 includes the preferences of the Americans, French, and Japanese. A third tier of capital is defined in the 1996 Market Risk Amendment to the original accord. Tier 2 describes supplementary capital elements and includes loan loss reserves, subordinated debt, and other instruments. Total capital consists of both tier 1 and tier 2 capital.

6.2.2. Pillar 1: Structural Differences over the Characteristics of Banks

There are three major categories of structural disagreement regarding Pillar 1: differential impact of capital due to the nature of the affected economy, differences in regulatory frameworks, and differences in risk profile of the banking systems.

6.2.2.1. Large International Banks versus Small Community Banks

This problem exists not only between countries but also within them and also between their respective regulators. In fact, there were three different capital regimes in the US: Basel II (Advanced and Standardized), Basel IA, and Basel I. This also was the cause of US – EU friction over the greater capital charge for Small and Medium-sized Enterprises (SMEs) on which the Europeans relied much more than the US banks.

Large international banks believed that Basel II would help them gain competitive advantages over the smaller domestic banks. The US political framework allowed them to voice their concerns and mobilize support or opposition to Basel II. Smaller banks--realizing that the implementation of Advanced Internal Ratings-based approach of Basel II by large international banks would place them at a competitive disadvantage--lobbied
Congress and the financial regulators to modify the A-IRB approach and allow them to continue using a modified standardized approach.

6.2.2.2. Universal Banks or Separate Commercial and Investment Banks

Whereas in the US, the Glass-Steagall Act separated commercial banking from investment banking, no such separation existed in continental Europe. Thus, continental European banks often traded in securities in the same entity with traditional banking activities. Hence, they were confronted not only with the traditional credit risk (the risk of a creditor defaulting), but also with market risks (the risk of a sudden decline in the value of securities held by a bank).237

6.2.2.3. Debate over treatment of Small and Medium-sized Enterprises (SMEs)

Two issues proved particularly salient in the further negotiations within the Basel Committee. Again, the United States was pitted against Germany, and there was extensive newspaper coverage of this “diplomatic row.” The first issue was the treatment of credit card debts, and the second (more important) one was the use of an external ratings system especially for SMEs. Credit card debts are a substantial part of the balance sheet particularly for American banks. A high risk-weighting of these debts would force the US banking sector to hold relatively larger amounts of reserve capital than their global counterparts do. Given the implications for the competitiveness of the US banking sector, this issue became a possible deal-breaker for the American representatives in the negotiations.
6.2.2.4. Sources of Commercial Credit: Banks or Capital Markets?

European bankers argue that tighter capital regulations would harm bank lending more than capital markets. Banks provide about 75 percent of financing to the economy in Europe, while 70 percent of lending in the U.S. comes from markets rather than from banks themselves. Since most European countries rely on banks much more heavily than capital markets, credit outstanding as a percentage of gross domestic product is almost twice as high in the 27-nation EU as in the U.S. According the Institute for International Finance Bank, bank assets represent 83.1 percent of gross domestic product in the United States against 346.6 percent for the euro area. Because the banks’ role in providing credit to businesses is also far more important in Europe than in the United States, European banks are pushing for a phasing-in period for Basel III regulations while the United States is pushing for much faster implementation. “The stakes in Europe are much, much higher.”

6.2.2.5. Number of Banks in the National Economy

Each state comprises a system of financial regulation unique to its historical circumstances. The US has tens of thousands of banks and a deep distrust of centralized financial power. Great Britain has a relative handful of banks. This results in each state having a unique set of evolving institutions with evolving missions serving economies with unique characteristics.

A state with a small number of institutions could adopt a regulatory system that allowed for a great deal of discretion of the part of regulators because they maintain close relations with the banks. As we have observed, this was true of the British financial
industry where the Bank of England was regarded as having the power to regulate by the use of the “raised eyebrow” to express implicit disapproval of a bank’s actions.

The US preference for a method of regulating the capital adequacy of banks differed from that of Britain primarily because the US banking system encompassed thousands of banks. Looking at the initial negotiations between the United States and Britain over Basel I, the UK had a system appropriate to a country with a very small number of banks compared with 7,635 FDIC-Insured Institutions in the United States as of February 2011.  

**6.2.2.6. Banks with Large Residential Mortgage Portfolios**

German regulators criticized the first Basel Committee consultative paper in 1999 because German banks specializing in residential loans would be adversely affected since they are classified as riskier than governmental or corporate loans. Germany has a competitive advantage over banks from other countries in the mortgage market, and that resulted in considerable delay in the Basel II negotiations. Not surprisingly, as Blom noted, the impasse was resolved by a compromise to allow national exceptions on mortgages.  

**6.2.3. Pillar 1: Risk Evaluation Methodologies**

Basel II was considered a major improvement over Basel I because it allowed for a much finer measurement (or “granularity”) of the risks inherent in the investments of banks. From the American point of view, the credit rating agencies (Standard & Poor’s, Moody’s and Fitch) were viewed as impartial and therefore reliable. However, this
became a divisive issue between the United States, the Europeans (led by Germany) and Japan.

Who decides how to measure risk? As described in the above section on the first Basel Accord, the determination of the requirement for regulatory capital is based on the categorization of the investments of the bank. The riskier the asset, the higher the required capital, and the lower the profitability (and desirability as a takeover target) of the bank. The foundation of the Basel I was that the amount of regulatory capital should be a function of the riskiness of its investment and trading portfolios.

Although Basel II allowed for the use of internal rating methodologies (in reality only available to the largest international banks), it relied heavily on the use of credit rating agencies in determining regulatory capital requirements. Since Germany and other members of the EU did not have a credit rating industry comparable to the US, this became a divisive issue between the US and Germany.  

A major departure between Basel I and Basel II was the agreement to allow banks to supply their own credit models to evaluate the riskiness of their assets and hence the amount of capital that they should be required to maintain. Banks argued that their internal credit ratings were more reliable than those of the credit rating agencies because they maintained methodologies that are more advanced.

Few companies in Europe and Japan, especially Small and Medium-sized Enterprises (SMEs), have such a credit rating and these would therefore get a 100% risk weighing and thus would fail to get high credit ratings even though they were excellent credit risks. SME associations feared this would increase their borrowing costs, because they
would become more expensive for banks to loan to. This became a major issue with Germany and, in 2002, German Chancellor Schroeder threatened to take the Germans out of the Basel II negotiations; to veto any European banking directive based on Basel II; and not to accept an Accord leading to higher borrowing costs for the Mittelstand.243

6.2.3.1. Differences in Accounting Methodologies: Comparing Apples and Oranges

Due to discrepancies between GAAP and IFRS, it is much more difficult to compare American and non-American banks. This contributes to the difficulty in applying a single global standard for capital adequacy. As a study in Global Governance, the Basel Process depends on international harmonization of accounting practice as well as agreements on the definition of capital, credit ratings, measurements of risk, and other technical subjects. What has been the impact of uncoordinated and large quantities of regulatory initiatives between Basel II and the International Financial Reporting Standards (IFRS) adopted by the International Accounting Standards Board (IASB)244 or Sarbanes-Oxley that promoted greater public disclosure over corporate balance sheets after the corporate scandals of early 2000’s?

In the case of accounting standards, the EU adhered to the International Financial Reporting Standards (IFRS) while the United States adopted the Generally Accepted Accounting Principles (GAAP). Tarullo has pointed out that this difference in standards could confer significant competitive advantage even if the cost of bank capital were roughly equalized.245

“There are hundreds of pages of GAAP covering how to account for derivatives, but this didn’t stop opaque pricing mismatches, which helped
create the credit crunch. GAAP rules allowed trillions of dollars in securitized financial assets and liabilities to stay off the books of U.S. financial firms, while the international standard, by focusing on the true underlying economics, kept these on the books for firms based elsewhere.”

The Securities and Exchange Commission announced that the U.S. would abandon Generally Accepted Accounting Principles by 2016. For almost 75 years, GAAP has been “the bible” for U.S. accountants. The U.S. will then join more than 100 countries in using the London-based International Financial Reporting Standards. As Crovitz explains, the international standard (IFRS) is based on principles, while GAAP, used in the United States, is based on rules. By relying on rules, the GAAP is much lengthier than IFRS in that it tries to set rules for all situations. GAAP thus fills a “nine-inch, three-volume set of pronouncements plus interpretive information [while] IFRS is a slim two-inch book.”

6.2.3.2. Leverage Ratios and Simple Measurements of Financial Risks

“Basel, in my view, was a total failure. None of the Basel changes will lead to the right result. What we learnt from the crisis is that simple leverage ratios prevented more damage from being done than Basel was doing,” said Hal Scott, a professor of international finance at Harvard Law School.

Leverage ratios are a simple capital to assets calculation. They are controversial since they prevent industry capital requirements from dropping more than 10% and are not broken down by the level of risk within an investment or type of asset. Leverage ratios are thus much easier to utilize. Opponents believe that leverage ratios place them at a competitive disadvantage relative to firms not subject to a similar requirement. Leverage ratios would also cap the size of a bank’s overall assets relative to its tier-one capital and encourage banks to take more risks to boost profitability.
Leverage ratios do not give added credit to banks with stronger deposit bases, differentiate between the creditworthiness of loan portfolios, or take into account banks that maintain higher loan-loss reserves. Furthermore, they do not resolve the issues of what to count as capital, for example, preferred or convertible instruments, deferred tax assets, or other capital investments such as software.

The denominator of a leverage ratio (total assets) is also controversial given the need to value (mark-to-market) traded positions rather than rely on notional, or face, value. In addition, the risk-weighting of securitizations is an inexact science. It also proved impossible to stick to the requirement that only permanent shareholders’ equity be counted as Tier 1 capital given international differences in tax and legal frameworks and pressures to include hybrid securities.

In the United States, depository institutions are subject to risk-based capital guidelines issued by the Board of Governors of the Federal Reserve System (FRB). The risk-based capital guidelines are supplemented by a leverage ratio requirement that is calculated:

- Equity + Reserves - Intangible assets = Tier 1 capital
- Total assets - Intangible assets = Adjusted assets
- Tier 1 capital/Adjusted assets = Leverage ratio

The U.S. version of Basel II contains notable differences from the international version, including a leverage ratio and capital floors. The politicians urged banking regulators to issue a final version of Basel II that does not differ dramatically from the international one. As we have mentioned, the use of leverage ratios is an issue that pits American
against European negotiators internationally and large banks against small
community banks domestically. This led American regulators to propose a “Basel IA
compromise” to avoid imposing the heavy costs on the small “non-core” banks that
would be needed to develop their own risk models.

In February 2007, four of the largest US banks asked regulators to remove the leverage
ratio from the Basel II capital proposal (Wachovia Corp., JPMorgan Chase & Co.,
Citigroup Inc., and Washington Mutual Inc.) when it became apparent that the regulators
were opposed to removing the leverage ratio. The major concern was that the use of
leverage ratios would give foreign banks a “competitive advantage,” and the banks
therefore urged regulators to allow the “standardized approach” to be implemented in the
US.250

The British Bankers Association called the new capital accord “completely unjustified”
as it would increase costs for banks. “Let us be under no illusion that the conditions
giving rise to the recent financial turmoil were stoked up in a Basel I environment in the
U.S.” 251

6.2.3.3. Basel III and the Leverage Ratio

In reaction to the financial crisis, US policymakers have advocated the leverage ratio as a
simpler alternative to the risk-based Basel II approach. However, as Vedi points out,
there is a trade-off between this increased simplicity of the leverage ratio and the
increased capital requirements expected to result. Increased simplicity may make bank
supervision more comprehensive and more difficult to “game the system,” but it will
slow down the ability of banks to lend and thus help pull the global economy out of its
prolonged recession.\textsuperscript{252} As Ezra Klein notes, “The reason they’re taking eight years to phase it in is that it’ll have a big effect on European banks. Our regulators already use a simple capital ratio, so this will not be a huge adjustment for our banks. The Europeans do not, so their banks hold more assets, but they are less risky. We have riskier assets, but fewer of them”.\textsuperscript{253}

Here then is a major point of disagreement between the US and the EU over whether Basel II needs to be renegotiated at all.\textsuperscript{254} The US favors negotiations leading to Basel III that will take more account of the failings of Basel II. A key point in this debate is whether to rely on the simpler approach to capital requirements by use of a leverage ratio or to continue to rely on the finer risk-weighting approach embodied in the Basel II approach.

\textbf{6.3. Pillar 2: Supervisory Review Process}

The Supervisory Review Process requires firms to demonstrate that their risk management systems and capital allocation processes are effective. Under Pillar 2, banks must have an internal process, which will be subject to rigorous regulatory review, ensuring that they are holding enough overall capital to support their entire risk profile.\textsuperscript{255} Regulators will take into account a bank's internal capital-adequacy assessment process, known as its ICAAP, and all other relevant information. The banking agencies expect banks to implement and continually update the fundamental elements of a sound ICAAP, that is, identifying and measuring material risks, setting capital-adequacy goals relating to risk, and ensuring the integrity of internal capital-adequacy assessments.
A bank is expected to hold adequate capital against all of its material risks, particularly those risks not covered or not adequately quantified in the risk-based capital requirements, such as liquidity risk. Under Basel II, ICAAP is a new requirement for financial institutions. In general, a bank's ICAAP should reflect an appropriate level of conservatism to account for uncertainty in risk identification, risk mitigation or control, quantitative processes, and any use of modeling. ICAAP requires assessments in four key areas: the risks a bank is, or may be, exposed to; steps the bank can take to help to lower capital requirements; stress-testing techniques; and a review of the role of the board of directors and management.

The process of negotiating, evaluating, soliciting outside opinion, and renegotiating the Accords has created a cohesive institutional forum for banking supervisors to learn to work together for years. Whether these professional civil servants are seen as acting primarily in the public interest or the private interests of the financial industry that they regulate, however, is yet again the issue of regulatory capture. Has it helped establish and deepen the transnational network of banking supervisors? Has it helped extend and deepen global networks enhancing the stability of the global financial system through the promotion of banking stability?

The regulation of banks and other credit-creating institutions demands sustained attention to subject requiring specialized expertise. The Basel Process has created and institutionalized a network of transnational banking supervisors who have become accustomed to listening to each other’s concerns on the implementation of the Basel Accords. If these supervisors remain participants (rather than seeking more lucrative positions in the regulated industry), they may seek compromises for the sake of the
overall enterprise rather than the interests of their own national constituency.

Transnational cooperation is achieved through “regulatory colleges” that bring together financial regulators to discuss regulatory issues associated with large banks on a worldwide basis.258

Bringing banking regulators together has built a spirit of cooperation and trust and increases the likelihood that there will be effective resolution of any future financial crisis.259 It may seem that in the recent financial crisis, that the national legislatures and finance ministries were the primary forces behind the efforts at rescue. But, as Pauly argues, “behind the scenes, the transnational network of state officials—from finance ministries to central banks to financial supervisors--expanded their collaborative work” thus saving the financial system from financial chaos.260

The framework of consolidated supervision through which Basel II is to be applied is a potential source of difficulties for, and thus may slow, implementation. This could be the case if the supervisor of an international bank in its parent country and that of a subsidiary or branch in a host country apply different rules. The parent supervisor might approve the bank’s adoption of the IRB approach, while the host supervisor might prescribe the Standardized approach for banks subject to its supervision owing to limitations on its supervisory capacity. In these circumstances--owing to fears about adverse competitive effects on domestic banks due the lower capital requirements and thus the lower costs associated with the IRB approach--it might well be unwilling to allow the foreign entity to use this approach and thus also to entrust supervision of its capital to the parent supervisor.261
The Basel Process reflected an emerging norm that bank supervisors should move away from strong prescriptions regarding the risk management practices of banks. Pillar 2 emphasized the necessity for supervising the adequacy of their internal controls. Pillar 3 facilitated a greater role for increased disclosure and market-based constraints on bank risk-taking. Both of these Pillars were strongly associated with the growing faith in the self-stabilizing nature of deregulated financial markets, something that Greenspan and other senior Fed officials had long accepted. The Global Financial Crisis has now shaken that confidence.

6.3.1. International Soft Law, Supervisory Discretion and Overlapping or Contradictory Regulations

Bank supervisors are explicitly granted the power to utilize discretion within the supervisory review in Pillar 2, although in fact these powers traditionally emerge from national regulations. Supervisory discretion is an openly recognized method by which to keep the Process moving forward despite irreconcilable differences or when regulations would produce unacceptably negative consequences for the “losing party.” Forbearance policies essentially meant government policies to provide “assistance to the existing management of insolvent banks, rather than close the banks or effect a major management shake-up.”

National regulators are also permitted a long list of exceptions to full implementation known as “supervisory discretion” within each banking system. Tarullo notes that the Basel Committee identifies *more than 60 areas* in which national discretion may be exercised. How far can discretion be extended? Is there any oversight of discretionary
powers? Does this body of international soft law incorporate so many exceptions as to render the final product wholly ineffective in preventing another global financial crisis?

As mentioned above, the Basel Accords are not the only efforts at international banking regulation. Parallel to the negotiations on the Basel Accords, the European Union continued its efforts at regional supervisory convergence with the 1993 Capital Adequacy Directive (CAD) that established uniform capital requirements for both banking firms and non-bank securities firms.265 The CAD was a significant development because it added a market risk element to the credit risk focus of the Basel I Accord, an innovation that would be included in 1996 with the adoption in 1996 of the Market Risk Amendment by the Basel Committee.266

These multiple overlapping regulatory efforts raise many questions that are hard to answer because much of the process has been so opaque. Was there any policy coordination between these independent sets of regulators? How did this effort affect further progress on Basel II through the Basel Committee? The parent supervisor might approve the bank’s adoption of the Basel II “internal-ratings based approach” (IRB) only available to very large banks, while the host supervisor might prescribe the Standardized (Basel I) approach for banks subject to its supervision owing to limitations on its supervisory capacity.267 What is the protocol for resolving disputes when the supervisor of an international bank in its parent country and that of a subsidiary or branch in a host country apply different rules?

U.S regulatory agencies may have believed that more than a single approach to a revised capital adequacy standard would minimize political obstacles to implementation between
core and non-core banks. The European Union, on the other hand, considered Basel II as an international standard to be incorporated in its Capital Requirements Directive that regulates all depository institutions and most types of investment firms.268

Some American trade associations have publicly advocated that the agencies permit wider choice for U.S. institutions, and in particular that they should be allowed to select either the standardized approach or a proposed new version of the existing capital standard, the so-called Basel I-A framework.269 The proposed Basel II standards to be applied in the U.S. were criticized as being inconsistent with the internationally agreed capital framework. Ironically, since the EU has fully adopted Basel II--while the US was still negotiating within the American financial system--the EU has more of a claim to leadership in advancing Basel III than the United States that initiated the Basel Process in the 1980’s. These topics will be discussed in Chapter 5 regarding the international financial diplomacy of the Basel Process.

The Basel II approach was opposed within the US “iron triangle” as an impossibly complex approach to the problem of capital adequacy that would require an army of regulators to implement. The Federal Reserve Bank of New York nevertheless claimed that it was up to the challenge since “we did a major reorganization a few years ago that really emphasized the importance of specialization. We have cadres of examiners that specialize by individual institution or class of similar institution….270

The need for “an army of regulators” is made even more of a challenge in view of how little fully-trained supervisors, steeped in the nuances of Basel II rules and regulations, are paid in comparison with their private-sector counterparts.271 The vast majority of US
banks demanded some simpler method of evaluating risk. In one Congressional hearing, a witness pointed out “that the regulators, in working the field tests, had themselves been lost for two months in trying to find a misplaced square root sign within the worksheets. Basel II, he said, is just too complicated.”

**6.4. Pillar 3: the “market discipline” pillar**

Can a bank be forced to disclose the state of its capital structure if it causes it a competitive disadvantage? Operational risk requires improvements in internal auditing, credit control, settlement systems management, business process, and human resources management. Power notes that half the banks in a 1998 survey by the Basel Committee had created an operational risk manager independent of business lines alongside the heads of credit and market risk, suggesting that the need to deal with the problem was taken seriously at least by some rather than being just as gesture to the regulators. Pillar 3 requires firms to publicly disclose certain information about their risk and capital management with the intention that disclosure will impose a degree of market discipline over the banks.
Chapter 7: Benefits and Costs of the Basel Process

7.1. Adding up the Benefits

It should be recalled that the central research question in this dissertation is: have the benefits of the Basel Process outweighed the costs? The question is a counterfactual: would the international financial system have been better off without the Basel Accords? How effectively has it controlled the amount and concentration of financial risk in the international financial system? Have the Accords helped to prevent systemic crises or caused the GFC by encouraging financial engineers to find new methods for evading the “Basel problem.” Could this have been achieved on a national level without the need for an international standard?²⁷⁶

In the chapters above, we have examined what I believe are the benefits of the Basel Process:

- Providing the public good of global financial stability through “crisis prevention” rather than “crisis management”

- “Leveling the playing field”

- Producing international soft law and strengthening legal frameworks

- Imposing Home country control over multinational banks

- Establishing regulatory colleges to oversee multinational banks

- Developing networks for coordination of supervision
Establishing an iterative process for proposing, evaluating, and amending regulations

While these benefits have not been fully realized (in substantial part, because of the constant struggle between the regulators and the regulated industry), they are worthwhile goals and should be continued under the aegis of the Basel Committee and the expanded role of the G20. In this chapter, we turn to the Unintended Consequences of the Basel Process.

7.2. Subtracting the Costs: Unintended Consequences of the Basel Accords

“What went wrong in September 2008 was not that the existing Basel II capital requirements were too low but that banks found a way around the rules. The shadow banking system evolved in response to this need, operating largely through the repo market...When the investors get spooked for some reason and all pull their money out at once, the banks can no longer make loans and credit freezes...In September 2008, investors were spooked when the mortgage-backed securities backing their repo “deposits” proved not to be “triple A” as represented.” 277

In Chapter 3, “Concepts and Controversies: The Basel Process and the Global Governance Literature,” a collection of controversies emerging from Innovations in Financial Markets, Products and Risk Management Techniques was discussed. In this section, those categories will be used to describe the Unintended Consequences of the Basel Accords.

A major reform of Basel II was to eliminate the loopholes in Basel I that allowed banks to take on additional risk while cosmetically seeming to meet minimum capital adequacy requirements. In order to prevent banks from “hiding” risk-taking by transferring its assets to other subsidiaries, Basel II required the inclusion of the assets of the holding
company of an internationally active bank so that the financial health of the entire firm was taken into account in the calculation of capital requirements for its subsidiary bank.  

Some critics of the Basel Accords have argued that as soon as the regulators issue new regulations, the financial industry immediately begins to test the limits of those regulations. This includes the explicit limits on existing business practices and instruments and encouraging financial innovations in entirely new pursuits, such as the creation of new financial instruments through securitization.

7.2.1. Increasing the Cost of Economic Growth during Recessions

Regulators have long appreciated that requiring banks to increase their capital during a recession (when the risk of default is increasing) intensifies the recession since banks are forced to reduce lending. [The procyclical nature of the Basel I and II has been discussed above in Section 2.2.2. (“Bank Capital Regulation and Global Economic Growth”) and Section 3.2.4. (“Controversies over Global Standards and National Business Cycles”)].

In an attempt to correct this undesirable side effect, a proposal for the establishment of Countercyclical Capital Buffers has been adopted in Basel III. This has been discussed above in Section 5.2.5.3.

7.2.2. Increasing the Cost of Capital and / or the Cost of Funds

Japan was accused of dumping in the euro markets by offering rates that could not be matched by European and US competitors. US bankers and policymakers noted “the capital ratios of both Japanese and American banks had moved inversely to their market
shares.” Japanese capital ratios declined from well over 3 percent to roughly 2 ½ percent while the capital ratios of the largest US, French, British and German banks all increased during this period and their market shares all fell. However, Tarullo makes the point that the “the most important source of Japanese bank competitive advantage lay \textit{not in its cost of equity capital but in its costs of funds}. Exclusion of foreign banks from Japan’s highly regulated deposit market was thus a major source of competitive advantage”.  

The Basel I standards also encouraged banks to invest in the riskiest investments within any given asset class since the cost in regulatory capital would be the same. Because all assets of a certain type are lumped together, banks had an incentive to take on the higher-risk assets (and to sell off lower-yielding assets) because they pay the same in capital as for lower-yielding assets. This is known as “cherry-picking” assets.  

“A related example was the profusion of loans up to 364 days being one day short of the next category of loans with a higher capital requirement. In this respect, Basel I thus had the unintended consequence of increasing the risk inherent in bank portfolios.
7.2.3. Removing Investments from Balance Sheets as a Solution to “the Basel Problem”

The major Unintended Consequence of the Basel Accords is the incentive to solve “the Basel problem” by removing investments from the balance sheets of the bank. Market participants needed to find a way to maintain revenues without increasing the size of their balance sheets since the more assets and investments are held on the balance sheet, the more capital is required. Eventually this gave rise to the need for more investment “vehicles” which constituted the “shadow banking system.” When the basis for these assets were transformed from corporate loans to mortgage-backed securities, the stage was set for the securitization revolution that, in turn, helped to fuel the housing bubble.

In the 1980’s, when the Basel Accords were initiated, financial innovation was in its relative infancy. Banks took deposits and made loans, and ensuring that they were over-leveraged was simply a matter of comparing their capital resources to their risk-adjusted assets and investments. Under Basel I banks were required to keep a minimum of 8 percent of their risk-adjusted assets and investments in capital. The risk-weighting scheme was very simple: there was no capital requirement for holding cash or short-term government securities as there was no perceived risk to these instruments. Exposures to banks within the OECD required a 20 percent capital backing. Residential mortgages required 50 percent backing. Unsecured commercial loans required 10 percent backing. Exposures to borrowers with poor credit ratings required 150 percent backing.

The financial innovation was to convert the investment into a financial instrument that could be sold on a secondary market (“over the counter”) to another bank or investor. In addition to enabling the bank to earn income from creating the investment without
requiring that it maintain capital to hold that investment, securitization also enabled banks to free up counterparty credit limits since they had created and sold the investment to other investors and it was no longer on their books.

To deal with “the Basel problem,” banks moved into securitizations and credit derivatives that would not increase their risk-weighted capital reserves. Would investors want to buy such instruments? Would regulators permit them to be sold? What would the possibility of trading default risk do to the financial world? It certainly created the incentive to devise complex instruments (like Collateralized Debt Obligations, or CDOs) and to leverage their derivatives with very little capital.\(^\text{286}\)

Banks quickly devised ways to get around “the Basel problem,” finding ways to create investments that generated income but at the same time removed those assets from their balance sheets to avoid the need to hold capital. This gave a great impetus to the securitization revolution. The following chart shows many of the classes of assets that can be packaged as securities and sold in the marketplace as asset-backed securities:\(^\text{287}\)

<table>
<thead>
<tr>
<th>Examples of Securitized Asset Classes</th>
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<tbody>
<tr>
<td>Aircraft leases</td>
</tr>
<tr>
<td>Equipment leases</td>
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<tr>
<td>Mutual Fund receivables</td>
</tr>
<tr>
<td>Auto loans (prime)</td>
</tr>
<tr>
<td>Equipment loans</td>
</tr>
<tr>
<td>Manufactured housing loans</td>
</tr>
<tr>
<td>Auto loans (subprime)</td>
</tr>
<tr>
<td>Franchise loans</td>
</tr>
<tr>
<td>Small Business Loans</td>
</tr>
<tr>
<td>Auto leases</td>
</tr>
<tr>
<td>“Future” receivables</td>
</tr>
<tr>
<td>Stranded utility costs</td>
</tr>
<tr>
<td>B &amp; C MBS</td>
</tr>
<tr>
<td>Healthcare receivables</td>
</tr>
<tr>
<td>Student loans</td>
</tr>
<tr>
<td>Computer leases</td>
</tr>
<tr>
<td>Health club receivables</td>
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<tr>
<td>Trade receivables</td>
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<tr>
<td>Conforming first-lien</td>
</tr>
<tr>
<td>Home equity loans</td>
</tr>
<tr>
<td>Time share loans</td>
</tr>
<tr>
<td>Non-conforming mortgages</td>
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<tr>
<td>Intellectual Property cash</td>
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<tr>
<td>Tax liens</td>
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<tr>
<td>Consumer loans</td>
</tr>
<tr>
<td>Insurance receivables</td>
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<tr>
<td>Taxi medallion loans</td>
</tr>
</tbody>
</table>
How far a law can be bent without breaking it is a natural reaction of institutions and individuals when profitability depends on such an agreement. Under Basel I, regulatory capital was based on the riskiness of the assets kept on the balance sheet of the bank. This basic approach to ensuring financial stability (“regulatory capital adequacy”) generated a need to find a way to create investments with maximum returns and minimal costs. The securitization revolution answered the need for financial instruments that could be readily sold to a secondary marketplace by a primary issuer.

If Global Finance were static, Basel I would have been good enough. States create banking regulations and empower banking regulators to examine the books of banks. As we have stressed, the interest of the banks is to lend as much as possible so that they earn as much as possible on the funds they have borrowed. The interest of the banking regulator is that the banks retain enough in liquid assets to meet the reasonable demands of depositors and to make sure that they bank has enough in case its investments go bad and become uncollectable.

Basel I did indeed create an incentive for bankers to devise ways to keep assets off their balance sheets. In addition to securitizing assets and selling them to the markets, banks defeated the purpose of Basel by “parking” investments in “structured investment vehicles” which lacked capital requirements. Was this deliberately hidden from regulators or did they seemingly condone it as was recently revealed about another technique used by Lehman Brothers called “Repo 105”? “The Lehman use of “Repo 105”
to disguise leverage in its accounts was not hidden from supervisors – it appears they
did not fully appreciate what they were looking at”. 288

7.2.4. Creating a False Sense of Security about Financial Risks

The first weakness is the illusion of safety that Basel II engendered; an illusion that
compliance with Basel II meant that bank capital would be adequate to withstand a crisis.

“The complacency engendered by Basel II resulted from two levels of
trust. The first was the trust that other actors were following Basel II
rules—and hence were minimally robust. The second, and more
dangerous, source of complacency was the trust that Basel II had been
designed well enough that when financial institutions complied, a systemic
meltdown was so remote as to be virtually impossible. In hindsight, such a
naïve view seems hard to imagine, yet banks and their regulators widely
shared this view prior to the Crisis.”289

This became the source of controversy not only between large international banks and
small community banks but also among their respective regulators as mentioned in the
previous chapter. Hence this gave rise to three different capital regimes in the US: Basel
II (Advanced and Standardized), Basel IA, and Basel I. This also was the cause of US –
EU friction over the greater capital charge for Small and Medium-sized Enterprises
(SMEs) on which the Europeans relied much more than the US banks.

As noted, another unintended consequence was the incentive banks were given to invest
in the riskiest investments within any given asset class since the cost in regulatory capital
would be the same. While a generous deposit insurance system will prevent a bank run,
with the central bank acting as a lender of last resort to prevent the default of banks, such
safety nets have led to moral hazard problems induced by the availability of two safety
nets.290
Before the Global Financial Crisis, the continual refinements, precise calibrations of capital requirements, and renegotiations of the Basel Accords conveyed the impression that financial risks were being effectively addressed. As Atik observes:

“The accuracy of many pre-Crisis credit ratings of complex financial products seems doubtful. The Crisis was replete with examples of securitization vehicles’ highly rated obligations becoming virtually worthless overnight. Much like the above-average children of Lake Wobegon, it is all too clear in hindsight that there were far too many AAA-rated assets around.”

As mentioned in Chapter 3, a focal point of the relationship between the Basel Committee and the financial industry is the Institute for International Finance (IIF) that advanced proposals in the early 1990’s to modify Basel I. An agreement affecting the amount of lending by the banking system of the advanced industrialized societies would obviously affect all economic and social sectors of society. The interests of such a wide spectrum of society are in theory articulated on such an arcane subject as the “harmonization of capital adequacy regulations” through congressional hearings, public interest groups, and elections.

The Basel I standards also encouraged banks to undertake riskier behavior if they know that the they will be charged the same capital charge for investments depending on the type of issuer they are dealing with. A major departure between Basel I and Basel II was the agreement to allow banks to supply their own credit models to evaluate the riskiness of their assets and hence the amount of capital that they should be required to maintain. Benink and Kaufman point out that one of the reasons for the modification of Basel I was to allow a more detailed calibration of credit risk and require the pricing of other forms of risk (i.e. operational). This was the position advanced by the Institute for International
Finance in the 1990’s based on the advent of sophisticated risk management systems to determine the minimum amount of capital the large banks should be required to hold by the regulators as a buffer against unexpected losses. It is only natural that such banks should be overoptimistic about their risk exposure in order to minimize the required regulatory capital and maximize their return on equity.

In addition, they advocated heavier reliance on the Pillar 3 form of market discipline. This implies dealing with the “Too Big to Fail” perception that encourages investors to ignore warning signs about the health of financial institutions that are believed to be “too big to fail.” To achieve this market discipline, Benink and Kaufman advocate that large banks be required to issue “uninsured subordinated debt as part of the regulatory capital requirement,” which would convince professional investors that their money was truly at risk with these large banks.

Banks preferred to use internal ratings versus “precommitment approach.” Tarullo calls this “a modest example of the influence of international institutional arrangements on domestic regulatory choices.” Allowing the largest international banks to devise and implement their own risk models (thus determining how much capital they needed to maintain), further empowered the credit rating agencies, which might be expected to be partial to those who pay them for their ratings. When the Basel Committee accepted the use of internal models in a revised Basel agreement, it immediately opened up yet another political debate between the large (“core banks”) and small community (“non-core banks”)
Another innovation at this time was the development of the Value at Risk (VaR) model that allowed an institution to quantify the sensitivity of all of its portfolios at any point in time. All of these developments contributed to the prevailing belief that the financial markets were becoming much more adept at controlling risks themselves with financial regulations. This tied in with the prevailing ethos of the Greenspan years at the Fed that the market was best at disciplining itself.294

Following the discussions in Europe and representing both the changing structure in the banking market and the increasing prominence of the VaR philosophy, the Basel Committee decided to develop a market risk amendment to Basel I as well.295

Use of the VaR methodology has its benefits and drawbacks. As a benefit, it allows portfolio managers and other financial decision makers to assess quickly and concisely the extent of financial risks in their portfolios. On the other hand, the process is procyclical and destabilizing since it prompts investors to sell assets when their portfolio's riskiness hits a trigger level. If only a few investors used the strategy, it might work. However, when these methodologies are in widespread use, the possibility that all participants will try to exit the market simultaneously is magnified thus further destabilizing falling markets. Reliance of the VaR methodology may also lead banks to overlend in good times and cut back too drastically when things go sour. This procyclical feature of Basel I may have been responsible for exacerbating panics like the Asian contagion of 1997 and the extremely sluggish recovery from the Global Financial Crisis.296
7.2.5. Institutionalizing Conflicts of Interest in the Credit Rating Process

As Indiviglio notes, the Dodd-Frank legislation eliminates private credit ratings from “all laws and regulations” to prevent the conflict of interest between the ratings agencies and the issuers of debt instrument. However, it undercuts the method of rating debt that is at the heart of the risk-weighting methodology on which the Basel Accords have been based since their inception. It is therefore an excellent example of the dynamics between *global governance* and *national governance* efforts to deal with the stability of the financial system.297

This point above leads to another weakness of the Basel Accords, the empowerment of private credit agencies, a topic that has been researched by Timothy Sinclair.298 The foundation of the Basel I was that the amount of regulatory capital should be a function of the riskiness of its investment (and trading) portfolios. How, and by whom, is riskiness assessed? To an American, the answer is obvious: rely on the credit rating agencies like Moody’s, Standard and Poor’s or Fitch. However, US-style credit rating agencies are not a universal phenomenon and their objectivity and methodologies are perennially matters for debate.

Although Basel II allowed for the use of internal rating methodologies (in reality only available to the largest international banks), it relies heavily on the use of credit rating agencies in determining regulatory capital requirements. Since Germany and other members of the EU did not have a credit rating industry comparable to the US, this became a divisive issue between the US and Germany.299 Similarly, the Enron scandal revealed that auditors tended to be deceptive and that the system of self-regulation by
public auditors needed a thorough overhaul. What was the impact on the design of the
Basel approach? Did it present a similar problem as the lack of credit rating agencies
within the EU?

The Shadow Financial Regulatory Committee has recommended the combination of a
simple leverage ratio and the use of subordinated debt as an alternative to the Basel II
approach of relatively complex calculations combined with supervisory discretion. In this
approach, equity holders would stand to lose their investments entirely, while holders of
subordinated debt would “have a powerful incentive to monitor banks and sell their debt
at the first sign of unwise risk taking.” The reliance on market discipline seen in this
proposal is much more consistent with the libertarian philosophy of replacing any “safety
nets” with the self-interest of investors. 300

7.2.6. Allowing the Financial Industry to Self-Regulate New Instruments

When new financial instruments are introduced, the industry seeks to work with financial
regulators to devise models for managing the risk inherent in them. This is necessary
because the regulators do not possess any ready-made financial models to analyze the
inherent risks and do not possess the staff resources to develop those models. Hence, the
fact that the financial industry was given the responsibility to develop models of market
risk does not represent a prima facie case of regulatory arbitrage or an abdication of
regulatory responsibility so much an accommodation to the reality that financial
regulators are denied the tools they need because of a political concession to believers in
the “free market”. Those instruments represent a challenge to financial regulators because
they allow for the accumulation of financial risk that affects the maintenance of financial stability.

The securitization revolution in the early 1990’s had a dramatic impact among financial regulators particularly after the 1994 crash of the market for a new variety of mortgage-backed securities known as CMOs (collateralized mortgage obligations). The 1990’s, it should be recalled, were also the era of new financial instruments and the financial engineering of the “structured finance” revolution.301

How did the willingness of regulators let the industry police itself (as described by Gillian Tett with the founding of ISDA – the International Swaps and Derivatives Association) impact the quality of the Basel II agreements? Why did the Federal Reserve Bank of New York’s allow industry self-regulation through ISDA of new off-balance sheet derivatives such as interest-rate swaps and credit-default swaps and keep them “over the counter” rather than being traded on centralized exchanges? What impact did the new value-at-risk models have on regulators? How did the investment banks find a way to mass-produce and bundle these instruments?

Tett has recounted the presentations made to New York Fed President Gerald Corrigan about new derivative instruments by Morgan Guaranty CEO Dennis Weatherstone and Peter Hancock, leader of the Morgan credit derivatives team.302 To ensure that they would be able to maintain self-regulation over these new instruments, the financial industry created the International Swaps and Derivatives Association (ISDA) and drew up a very detailed set of industry “best practices”. The Federal Reserve Bank of New
York accepted ISDA guidelines. However, these new derivatives exacerbated the capital adequacy problem by allowing banks to “sell off” credit risks to the market.

Out of fear that the regulators would reduce the profit potential of swaps and other OTC derivatives, a group of bankers working for Salomon Brothers, Goldman Sachs, JP Morgan, and others allowed the International Swaps and Derivatives Association in 1985 to represent the industry. They launched an aggressive campaign to prevent the adoption of any heavy-handed regulations.

That was the impetus for Corrigan summoning Weatherstone and Hancock to his office in January 1992. At the same time Mark Brickell, a member of Hancock’s team, received an invitation from the G30 (“a group of highly influential group of economists, academics and bankers with a mission to promote better international financial cooperation”) to help write a study of derivatives. “What made ISDA’s approach so different was that it asserted that rules were best designed by the industry itself and upheld by voluntary, mutual accord”.  

The ISDA report, released in July 1993, became “the bible” of the derivatives industry and helped preempt unwelcome regulations. In early 1994, an unexpected increase in interest rates caused several participants in the growing derivatives to take large losses, including Proctor & Gamble, Gibson Greetings, Mead Corporation, Paine Webber, Askin Capital Management, and Orange County, California. The reaction was a sharply critical report of the new ISDA guidelines by the General Accounting Office (GAO) and actions by the Congress. Greenspan weighed in on the anti-regulation side of ISDA and the need to pursue formal regulations faded especially after Corrigan left the Federal Reserve
Bank of New York in 1993. The four anti-derivatives bills in Congress were shelved and, as Tett comments, “self-policing had won the day.”

7.2.6.1. BISTRO, Credit Default Swaps and the Derivatives Dream

Basel I did indeed create an incentive for bankers to devise ways to keep assets off their balance sheets. Tett describes the “BISTRO” concept whereby the newly invented credit-default swaps were packaged and sold to the credit markets, thus removing the credit risk from the balance sheets of the investors. To the traders, “BISTRO” was an acronym for “BIS (Bank for International Settlements) Total Rip-Off” meaning that it was yet another way to evade the “Basel problem” by securitizing and selling off assets to markets. When the value of the mortgages began to collapse in 2007, there was very little capital to maintain the value of those mass-produced securities.

As Tett describes in Fool’s Gold the credit crisis was exacerbated by the use of derivatives based on mortgages CDOs that were held in the SIVs of the banks. As long as CDOs could be used as collateral for repos, everything was fine – the securities were “self-financing” precisely because they could be used as collateral. Once investors began to doubt the value of those CDOs because of the bursting of the housing market bubble, those securities were no longer self-financing. As Tett describes it, the regulators were blindsided by the use of SIVs to house massive positions in CDOs and other exotic instruments. Once the banks were required to bring these exotic securities back on their balance sheets, they could not raise enough capital to maintain the minimum required level of regulatory capital. The resulting lack of confidence in the continued viability of
“systemically important” institutions resulted in the “freezing up” of credit in the global capital markets.

The final element in this solution to “the Basel Problem” was credit default swaps. They enabled BISTRO deals to be “industrialized,” pooling together individual loans to create securities based on the riskiness of each tranche. This extended the securitization concept that had been developed in the 1960’s and 1970’s to allow banks to sell off mortgage loans. These risk levels were divided into the riskiest (“junior”), the middle (“mezzanine”), and the least risky (“senior”).

Credit default swaps are an insurance product that offers the buyer protection from a default on a bond or a loan in exchange for a series of payments to the protection seller. This is not a “swap” as in a foreign currency swap or an interest rate swap. CDS are the financial instruments that make it possible to bet against (or “take a short position” on) sovereign debts, corporate bonds, mortgage backed securities, and other financial contracts in an unregulated market.307

When the Basel Accords were initiated, financial innovation was in its relative infancy. Banks took deposits and made loans, and ensuring that they were over-leveraged was simply a matter of comparing their capital resources to their risk-adjusted assets and investments. Under Basel I, banks were required to keep a minimum of percent of their risk-adjusted assets and investments in capital. The risk-weighting scheme was very simple. There was no capital requirement for holding cash or short-term government securities since there was no perceived risk to these instruments. Exposures to banks within the OECD required a 20 percent capital backing; residential mortgages required 50
percent backing; unsecured commercial loans required 100 percent backing and exposures to borrowers with poor credit ratings required 150 percent backing.

The next challenge was to find a way to “industrialize” CDS deals to realize their full profit potential. “That was the dream: credit derivatives would allow JP Morgan – and in due course all other banks, too – to exquisitely fine-tune risk burdens, releasing banks from age-old constraints and freeing up vast amounts of capital, turbo charging not only banking but the economy as a whole”.308

The next challenge was to persuade regulators at the Federal Reserve and the Office of Controller of the Currency. Their question was “if banks used credit derivatives to shift their default risk, would the regulators let them cut their reserves”?309

In addition to enforcing capital adequacy standards, regulators regulate financial instruments, for example stocks and repos (after the 1982 Drysdale scandal). JP Morgan’s credit derivatives team sought to shift that credit risk off its books, so that both the ‘credit limit’ headache and the ‘Basel’ problem might disappear.”310 In fact, a journalist from Dow Jones, Paula Froelich, who had extensive with this team at that time recalled: “They thought they were the smartest guys on the planet. They had found this brilliant way to get around the [Basel] rules, to play around with all this risk. And they were just so proud of what they had done”.311

At first, the regulators at the Office of Controller of the Currency and the Federal Reserve indicated that they would require Morgan to maintain 2 percent of the normal 8 percent capital requirement on the safest tranches (dubbed “super senior” by the inventors) of Morgan’s BISTRO securities. The use of credit default swaps convinced the regulators
that the credit risks were truly negligible. However, since it was negotiated before the securitization revolution, it needed major revisions. Instead of creating and holding mortgages and loans to maturity, banks could package them up in securities that were sold off to the markets. They earned their fees while not tying up capital.

Also fueling the growth of CDOs was the “yen carry trade.” Since Japanese interest rates were essentially zero, it was very profitable to borrow “free yen,” convert it to US dollars and invest in high-yielding assets like CDOs. The aim was to get a credit rating that was high enough so that the securities are investment grade and these instruments could be used as collateral in the market for repurchase agreements (“repo market”).

7.2.6.2. “Completing Credit Markets” through Credit Default Swaps

The introduction of an insurance product known as a “credit default swap” (CDS) has caused financial risks to be transferred entirely out of the banking system and into the insurance sector where the Basel Accords do not apply. This is not a theoretical possibility or one that is just in its infancy. By September 2008, the CDS market had grown to $62 trillion and the potential collapse of AIG thus overshadowed the consequences of the collapse of Lehman Brothers.

The immediate problem was that American International Group’s London subsidiary, AIG Financial Products, did not have the capital to back up their financial commitments. If the credit rating of AIG had been lowered, the insurer would have been forced to raise cash in a tightening credit market due to the substantial drop in the value of their contracts. The consensus is that the undercapitalization of the insurance sector due to CDS helped to bring the global financial system to the brink of collapse.
As Blundell-Wignall and Atkinson explain, CDS “complete” the credit markets, making it to bet on a price decline (“go short”) on financial instruments where such a possibility did not previously exist. This presents two challenges to financial regulation: incorporating the greatly enhanced riskiness of assets and investments and regulating the market itself for those “credit derivatives.” They argue that the Basel risk-weighting approach has allowed banks to expand their leverage almost without limit for all practical purposes. If banks have the ability to expand their leverage almost without limit, the Basel approach to achieving global financial stability is necessary but not sufficient.

Mispricing the risks in certain trades will cause market participants to take the same financial gamble since it seems so underpriced as to be irresistible. They may carry slightly more than the regulatory capital minimum that makes it look like they are safe and secure. Actually, the risks were drastically underpriced.

**7.2.7. Sanctioning Unregulated and Under-capitalized “Shadow Markets”**

What is the financial justification for allowing over-the-counter transactions between banks and other investors rather than requiring that all transactions be done on public exchanges? On public exchanges, “the market” and the regulators can see the most recent transaction prices as well as monitor the build-up of excessive and potentially disruptive long and short positions in a variety of financial instruments, particularly financial derivatives. However, if the financial industry used its lobbying effectiveness to prevent the regulation of new financial derivatives (such as credit default swaps), then the regulators could not prevent the over-leveraging of positions taken in over-the-counter financial instruments.
On the origin of the somewhat misleading term “credit default swaps,” former Federal Reserve Board member Alan Blinder reports: “I have heard it claimed that AIG and others fashioned these contracts as swaps, rather than as insurance policies, to avoid insurance regulation and capital requirements.”

Seeking input from the financial industry on evaluating the risks presented by new financial instruments may seem like a prima facie case of regulatory capture, insofar as the regulators are asking the regulated industry to regulate itself. However, it seems just as likely that the regulators are demanding that the industry utilize its resources since the regulators do not possess the tools (or the resources to develop those tools) for analysis. This is certainly preferable to simply developing guidelines on the treatment of new financial instruments without empirical evidence on which to base those guidelines.

As we have observed, the financial innovation was to convert the investment into a financial instrument that could be sold on a secondary market (“over the counter”) to another bank or investor. In addition to enabling the bank to earn income from creating the investment without requiring that it maintain capital to hold that investment, securitization enabled banks to free up counterparty credit limits since they had created and sold the investment to other investors and it was no longer on their books.

The real economy needs credit, and choking it off by over-regulating the banks will kill the real economy. Indeed, according to Gary Gorton, the shadow banking system evolved because banks were already so over-regulated that they could not turn a profit.

Holding loans on the balance sheets of banks is not profitable . . . . This is why the parallel or shadow banking system developed. If an industry is not profitable, the owners exit the industry by not investing; they invest
elsewhere. *Regulators can make banks do things, like hold more capital, but they cannot prevent exit if banking is not profitable.* ‘Exit’ means that the regulated banking sector shrinks, as bank equity holders refuse to invest more equity.\(^3\)

In sum, the Basel Accords gave bankers the incentive to move assets and investments off their corporate balance sheets into the unregulated “shadow banking system”; to pursue the highest risks available while staying within the guidelines for regulatory capital; to trade without a central clearinghouse; and to create risks to the entire financial system because of the highly leveraged positions.\(^3\)

We can distinguish between three types of institutions. Conventional commercial banks that take deposits from individuals and corporations that raise funds in the interbank market are subject to the full-range of regulatory controls, including the capital adequacy regulations of their home jurisdiction as well as the Basel Accords. These banks and corporations can turn to as the “lender of last resort” in case of financial emergency.

Investment banks were the second type of credit-creating institution before the Panic of 2008. They raised funds in the interbank market as well as through other financing mechanisms such as the “repo market” with corporations and other investors. They were subject (in the United States) to lower capital requirements and not ordinarily privileged to use the “lender of last resort.”

The third types of credit-creating institution are the hedge funds. These are the least regulated of the three types of institutions but, interestingly, were not the ones implicated as the culprits in the Panic of 2008.\(^3\)
The Treasury Blueprint’s proposal to merge banking regulators obscured part of the complex reality that was seen during the subprime crisis and the ensuing credit crisis. First, not all of the institutions that lend or otherwise provide capital are banks. The additional non-depositary institutions, which journalists sometimes collectively call the “shadow banking system,” include broker-dealers, hedge funds, and private equity firms. Although none of them had been regulated as depository institutions, after September 2008, the remaining investment banks were converted to bank holding companies regulated by the Federal Reserve in order to be able to qualify for financial assistance. In addition, the “shadow banking system” included unregulated legal entities created as part of the securitization process, notably structured investment vehicles (SIVs). SIV assets were frequently absorbed back into the banking system by sponsoring banks because of the reputation risk to those banks of not standing behind those vehicles. By 2007, the combined assets of all the SIVs and similar vehicles came to $2.2 trillion, while hedge funds controlled another $1.8 trillion, and the five largest investment banks had $4 trillion on their balance sheets whereas banks as a whole had $10 trillion in assets.320 Far from being a mere tail on the formal banking system, these “off-balance sheet vehicles” were a systemic threat to the overall financial system.

7.2.7.1. Special purpose vehicles (SPVs)

The final piece of the strategy was to utilize special purpose vehicles (SPVs) so that the CDS instruments would not be on the books of the bank. Once Moody’s gave these instruments AAA ratings, the financial innovators from JP Morgan approached the regulators. The regulators would only allow banks to cut capital reserves if they had truly removed the risk of loans from their books. That was accomplished by creating a “super-
senior” risk pool. AIG Financial Products agreed to insure the “super senior” portions of the BISTRO securities. Unfortunately, this decision of AIG was hardly regulated by the Office of Thrift Supervision. Relying on the super-senior concept, the regulators decided that the securities were now so safe that the capital backing could be drastically reduced and kept on the bank’s books.

Despite this effort, a related innovation was the creation of legal entities that held securitized investments of the banks. Instead of selling the investment to the secondary market, the bank transferred ownership to a legal entity and thus removed the investment from its own balance sheet. As long as the securities remained on the books of the “structured investment vehicle” (SIV), the bank did not need to maintain to back up the security.

Gorton and Metrick argue that it was the wholesale run on the sale-and-repurchase (repo) market during 2008 that caused the crisis. They suggest that new regulation could actually improve the functioning of the shadow banking system by making it less vulnerable to panics and crises of confidence.321

Despite this effort, a related innovation that came to play a major part in causing the Panic of 2008 was the aforementioned creation of legal entities that held securitized investments of the banks. Instead of selling the investment to the secondary market, the bank transferred ownership to a legal entity and thus removed the investment from its own balance sheet. As long as the securities remained on the books of the “structured investment vehicle” (SIV), the parent banks did not need to maintain capital to back up the security.
Some securitized offerings involved several AAA tranches. In such cases, the top tranche was commonly called the “super senior” tranche because it received income even before other AAA tranches. Banking institutions attempted to protect themselves by buying only super senior tranches, and some originating banks retained the super senior tranche on their own books. However, these super senior tranches also experienced losses under mark-to-market accounting. Investors fled the entire residential mortgage sector and were forced to sell in order to avoid liquidity problems.322

7.2.8. Merging with other economic forces to create the “perfect storm”

The Unintended Consequences of the Basel Accords provided the necessary, but not sufficient, conditions to produce the Global Financial Crisis. In this section, the other economic forces will be discussed. Several of these economic forces, while vital to understanding the causes of the GFC, will only be briefly mentioned since they are outside of the scope of this dissertation.

7.2.8.1. Pressures in the financial industry

A number of economic forces added pressure on the financial industry to increase financial leverage and reduce capital levels in order to maintain the highest returns on equity possible. These forces included the steady deregulation of the financial industry, beginning in 1975 with the abolition of fixed commissions on stocks; conversion of private partnerships of investment banks into public corporations; diminishing profit margins on traditional banking products; and intensifying competition through repeal of the 1933 Glass-Steagall Act in 1999.323 The repeal of Glass-Steagall also encouraged the consolidation of commercial and investment banks and insurance companies and
increased reliance on the Federal Reserve to act as lender of last resort. That, in turn, sanctioned morally hazardous financial practices that culminated in the subprime mortgage crisis of 2007.

7.2.8.2. The “global imbalances” and Bretton Woods 2

The global imbalances refer to the current account imbalances between the United States and the emerging market economies. Because of the low and stable interest rate environment maintained by the United States, global investors were force to increase the riskiness of their portfolio. China and other emerging markets with positive export earnings practiced policies of reserve hoarding in order to protect the value of their currencies from appreciation. These large pools of capital flowed back into the US and helped inflate the housing bubble and maintain supports for financial markets that collapsed in 2008.

Overall, the proponents of the “Bretton Wood 2” thesis (BW2) presented a vision of an implicit agreement between the “center” (the US and most highly developed economies of Europe) and the “periphery” (the emerging export-driven economies). BW2 was based on an implicit bargain between the “center” and “periphery” of the world economy that the agreement is in the best interests of all participants and hence, likely to remain stable for 10-15 years.

Dooley, Folkerts-Landau and Garber have maintained that these capital inflows were not to blame for the GFC. They argue that the huge capital inflows into the United States did not create the conditions for the bursting of the housing bubble or intensify the global financial crisis after the bankruptcy filing by the financial firm, Lehman Brothers, on
September 15, 2008. Rather, the true culprit in causing the crisis was the weak regulatory system exploited by unscrupulous originators and traders of mortgage-backed securities and other derivatives financial instruments such as credit default swaps and collateralized debt obligations. In short, they argue, the cause of the crisis is within, and not outside, the US. The following quote sums up their argument:

“Imagine a global system with permanent 4% equilibrium real interest rates. Now imagine a system with permanent 2% real interest rates. Why is one obviously more prone to fraud and speculation than the other? The vague assumption seems to be that capital inflows were large and interest rates were low, and this encouraged “bad” behavior.”

7.2.8.3. The Global Savings Glut

The “emerging market” states lack the financial capacity to invest export earnings in home markets and so invest their savings in the OECD countries where markets are relatively safe and secure. This is certain to be heavily influential in defining international economic policy because it is a deeply held view of the Chairman of the Federal Reserve, Ben S. Bernanke:

“…I see …the emergence of a global saving glut in the past eight to ten years. the strong saving motive of rich countries with aging populations, which must make provision for an impending sharp increase in the number of retirees relative to the number of workers”

This savings glut thesis does not only reflect Sino-US “co-dependency” but also current account surpluses of big wealthy countries like Japan and Germany. These too are rapidly aging, high-saving societies with limited domestic investment. As Chinn has pointed out, the global savings glut view may be theoretically sound because it is based on a mutual willingness on the part of Americans to continue unsustainable levels of consumption while China willingly provides the financing which keeps US interest rates low.
7.2.8.4. The Subprime Mortgage Frenzy and Housing Bubble

This helped fuel the housing bubble and led to its inevitable bursting.

This topic is not treated in depth in this dissertation because it is fully covered elsewhere, for example in the Financial Crisis Inquiry Report, Chapters 5-12.\textsuperscript{328}

7.2.8.5. Embedded reliance on the Lender of Last Resort to do “whatever it takes”

There is a deeply held faith that a Lender of Last Resort (and insurer of bank deposits) will rescue many types of “systemically important” and / or “too interconnected to fail” financial institutions. The repeal of the Glass-Steagall Act that separated commercial banks from investment banks and allowed banks to become “too big to fail.” This strengthened the deep faith in the “lender of last resort” (and insurer of banking deposits) role of government.

Please see Chapter 3 “Moral Hazards and the Libertarian Critique of Global Governance” for further discussion.
Conclusion: The Net Contribution of the Basel Accords to the Governance of Global Finance

The concluding chapter has two purposes. First, it will summarize the research and the conclusions in each of the preceding chapters. Second, it will assess the future of the Basel Process from a global governance perspective. This assessment will include the tension between the initiatives of individual states and the global Basel III proposals of the expanded G20 as efforts to recover from the Global Financial Crisis play out in the years ahead.

8.1. Summary of the Dissertation

8.1.1. Overview of the Dissertation

The Basel Accords were an essential building block for achieving global financial stability once the Bretton Woods system was abandoned and international capital flows became increasingly unregulated. However, the efforts over the past three decades to enhance global financial stability have been complicated by many factors such as structural differences in economies, types of governments and regulatory practices and the diversity of financial institutions. The chapter concluded by noting that the Basel Accords have given market participants the incentive to evade regulations and create financial risks in new markets.
8.1.2. What is the Net Contribution of the Basel Process to the Governance of Global Finance?

The research question presented in the second chapter was framed as an assessment of the net contribution of the Basel Accords to the governance of global finance given its costs and benefits. The question is a counterfactual: would the international financial system have been better off without the Basel Accords?

It presented a methodology for assessing the costs and benefits of the Basel Process based on the identification of intended consequences and unintended consequences. This dissertation has not utilized any quantitative measurement for assessing the benefits of the Basel Process. This dissertation has not attempted to “grade” the Basel Accords numerically because that narrows the focus of what is being evaluated too drastically.

The major intended consequences is, of course, the achievement of global financial stability by ensuring that financial risks are proportional to the amount of capital required to cushion the banking system given a predictable losses from credit risks, market risks and other operational risks that financial institutions always face.

The unintended consequences are the side effects of those regulations, which result in financial risks being accumulated outside the banking supervisory framework of the Basel Accords. In other words, Basel I created the incentive to solve “the Basel problem” by removing investments from the balance sheets of the bank. This practice, known as “regulatory capital arbitrage,” is not to be confused with “regulatory arbitrage” (shopping for the most lenient regulator whenever possible).
The “net contribution to the governance of global finance” is simply the benefits minus the costs of the Basel Process.

### 8.1.3. Concepts and Controversies: The Basel Process and the Global Governance Literature

Chapter Three has framed this study of the Basel Process within the literature of Global Governance. The main concern of that literature is the interaction of political and economic forces shaping the regulations and standards that govern the global banking industry.

Several concepts and paradigms, or ways of looking at the issues, have been described. In order to contribute to the literature on the governance of the global finance system, this dissertation has identified eight categories of controversies that emerge from the study of the Basel Process. These controversies emerge from structural differences between national financial systems, innovations in financial markets and risk management techniques, negotiating processes, challenges of implementation and enforcement and necessary improvements in how progress towards more effective global governance is measured.

Any discussion of Global Governance inevitably has to deal with the issue of the “democratic deficit” which reflects the unrepresentativeness of the process of arriving at global agreements. In short, how can so many countries with so little input from many of them implement such an agreement based on international “soft law”? Related to that issue, as centers of power and production spread from advanced industrial to emerging market economies, how can global financial policymaking be made a more inclusive
process and accommodate the shift to a “multipolar” global financial system? The
chapter concluded that the “Basel process” has suffered from a “democratic deficit”
whereby the vast majority of countries observing the Basel accord were excluded from
the decisionmaking process.

The final controversy posed by the Basel Process for global governance comes from the
libertarian critique of governance of global finance. Basel presented incentives for banks
to get increasingly involved in more risky operations given the availability of two safety
nets: on the one hand, a generous deposit insurance system to prevent a bank run; on the
other hand, the central bank as a lender of last resort to prevent the default of banks.
These safety nets have led to moral hazard problems.

8.1.4. Who’s Who? The International Political Sociology of Basel

Chapter Four looked at who is involved in the Basel Process. There are over 120 states
participating in the Basel Process. Within each state, types of actors can be identified
from the various branches of government and actors related directly or indirectly to the
financial industry. In order to utilize the global governance perspective, it is crucial to
appreciate that these actors interact with each other not only within but also across
national borders. The transnational aspect of the Basel Process is of primary interest to
students of global governance.

Global governance of financial markets on the national level involves nations,
legislatures, judiciaries, bureaucracies, central banks, national finance ministries,
businesses, academic experts, mass media, and others. On the international level, it
requires international financial institutions, including the familiar Bretton Woods
institutions and other institutions and less-formal arrangements. Their central task is the harmonization of capital adequacy standards and other safety and soundness measures.

The chapter also a spectrum of states ranging from the conservative to the liberal defined by their attitudes towards the definition of bank capital. At one end of the spectrum was Germany, the bastion of financial conservatism. To the Germans, capital consisted of fully paid-in capital that was certain to be available as a cushion in times of crisis.

The German position stood in stark contrast to the much more liberal Japanese stance on the definition of regulatory capital. The Japanese apparently could not easily agree to the harmonization of international capital standards because their banks were carrying so many bad loans and their economy was so deeply mired in recession for the collapse of their stock market in 1989. The Japanese Ministry of Finance therefore allowed a much looser definition of what is capital to included unrealized profit on securities.


Chapter 5 discussed the when, where and how questions related to the Basel Process. Although there are no formal negotiations, one assumes that the stages of formal diplomacy are discernible. After three decades of ongoing discussions about the international harmonization of regulatory capital, certain patterns are identifiable in this “iterative” process. A brief historical chronology of the Basel Process from the 1980’s to the current Basel III phase was presented. It revealed a definite pattern including the announcement of proposals by the Basel Committee, the evaluation by the financial
industry, the reformulation and reissuance of proposals. The conclusion was that although the Basel Process is deliberative and expertly guided, it has failed to bring about the measure of global financial stability required to prevent the recent global financial crisis.

8.1.6. What Issues are on the Table? International Political Economy of Basel

In Chapter Six, this dissertation has dealt with the “what question”. What issues are “on the table”? What have been the subjects that have apparently been so difficult to resolve within the Basel Committee? The chapter was organized around issues belonging to the three “pillars” of the Basel II Agreement: (1) minimum capital requirements, (2) the supervisory review of an institution's internal assessment process and capital adequacy; and (3) the effective use of disclosure to strengthen market discipline as a complement to supervisory efforts.

The chapter concluded that there are three major categories of structural disagreement regarding Pillar 1: the differential impact of capital due to the nature of the affected economy, differences in regulatory frameworks, and differences in risk profile of the banking systems. For example, while Basel II was considered a major improvement over Basel I because it allowed for a much finer measurement (or “granularity”) of the risks inherent in the investments of banks, reliance on credit rating agencies became a divisive issue between the United States, the Europeans (led by Germany) and Japan.

The Supervisory Review Process of Pillar Two requires firms to demonstrate that their risk management systems and capital allocation processes are effective. It was argued
that the process of negotiating, evaluating, soliciting outside opinion, and
renegotiating the Accords has created a cohesive institutional forum for banking
supervisors to learn to work together for years. Whether these professional civil servants
are seen as acting primarily in the public interest or the private interests of the financial
industry that they regulate, however, is yet again the issue of regulatory capture.
Transnational cooperation has also been advanced through “regulatory colleges” that
bring together financial regulators to discuss regulatory issues associated with large
banks on a worldwide basis. Finally, it was argued that bringing banking regulators
together has built a spirit of cooperation and trust that increases the likelihood that there
will be effective resolution of any future financial crisis.

The third pillar of Basel II, the “market discipline” pillar was briefly discussed. The
conclusion was that, while in theory it seems a constructive addition to the Basel Process,
it is limited in practice since banks cannot be forced to disclose the state of its capital
structure if it causes it a competitive disadvantage. In fact, revealing deteriorating
financial conditions may hasten the coming of a financial crisis if it leads to a stampede
for the exit by investors.

8.1.7. Costs of the Basel Process

Having explored the benefit side of the ledger of the Basel Process in the preceding
chapter, the dissertation turns to the cost side of the ledger in Chapter Seven. As
explained in Chapter Two, the costs are the result of the unintended consequences of the
Basel Process. That is, they were not the intended consequences that were not achieved
because of the conflicts of interest experienced by financial regulators who have been
“captured” by the industry they were selected to regulate. The costs under discussion in this chapter are those which no regulator would have deliberately have selected or favored as goals in the public interest. Had this dissertation been written before the Global Financial Crisis, most of these costs would not have been mentioned in a dissertation on the Basel Process.

The major Unintended Consequence of the Basel Accords is the incentive to solve “the Basel problem” by removing investments from the balance sheets of the bank. Market participants needed to find a way to maintain revenues without increasing the size of their balance sheets since the more assets and investments are held on the balance sheet, the more capital is required. Eventually this gave rise to the need for more investment “vehicles” which constituted the “shadow banking system.” When the basis for these assets were transformed from corporate loans to mortgage-backed securities, the stage was set for the securitization revolution that, in turn, helped to fuel the housing bubble.

As outlined in Chapter 3 (“Concepts and Controversies: The Basel Process and the Global Governance Literature”), a collection of controversies emerging from innovations in financial markets, products and risk management techniques was discussed.

A major departure between Basel I and Basel II was the agreement to allow banks to supply their own credit models to evaluate the riskiness of their assets and hence the amount of capital that they should be required to maintain. The chapter concluded that the continual refinements, precise calibrations of capital requirements, and renegotiations of the Basel Accords conveyed the impression that financial risks were being effectively addressed.
When new financial instruments are introduced, the industry seeks to work with financial regulators to devise models for managing the risk inherent in them. This is necessary because the regulators do not possess any ready-made financial models to analyze the inherent risks and do not possess the staff resources to develop those models. The chapter concluded that giving the financial industry responsibility to develop models of market risk does not represent a prima facie case of regulatory arbitrage or an abdication of regulatory responsibility so much an accommodation to the reality that financial regulators are denied the tools they need because of a political concession to believers in the “free market”. Those instruments represent a challenge to financial regulators because they allow for the accumulation of financial risk that affects the maintenance of financial stability.

8.1.7.1. Merging with other economic forces to create the “perfect storm”

The Unintended Consequences of the Basel Accords provided the necessary, but not sufficient, conditions to produce the Global Financial Crisis. In the final section of the chapter, the other economic forces producing “the perfect storm” were discussed. The forces included competitive pressures in the financial industry (which no longer acted merely as a “public utility” for the creation and distribution of credit); the “global imbalances” and “global savings glut” which contributed to an environment of low marketplace volatility and a feeling that increasing financial risks could be safely, if somewhat recklessly, pursued. The final ingredient was the subprime mortgage frenzy and oversupply of housing in the United States leading to the eventual collapse of the housing bubble.
The conclusion of this chapter is that although the Accords have contributed to the stability of the international banking system, they have also given market participants the incentive to evade regulations and create financial risks in new markets. Since these were insufficiently regulated and financial risk grew in the grossly under-capitalized “shadow banking system,” the Basel Accords directly contributed to the Panic of 2008 and the Global Financial Crisis.

8.2. The Future of the Basel Process and the Governance of Global Finance

“First, to what extent did Basel II fail to prevent the Crisis? That is, was the Basel system insufficiently robust to withstand the liquidity crisis and capital shrinkage that precipitated particular bank failures? And more pointedly, did Basel II contribute to the creation of the conditions that led to these failures?”329

“… The credit crunch began in summer 2007, which means that Basel II had not been implemented to any great extent beforehand. This is an important point to grasp, because the events that brought about the present global financial slowdown were in preparation for many years prior to 2007. Basel II, then, is not responsible for the crash, and it is not a failure because of the crash.” 330

“Basel III will be a very different animal,” said Charles Goodhart, a former Bank of England policy maker and professor at the London School of Economics. “We can say with conviction now that Basel II failed. It led to a relaxing of capital minimums. Regulators now understand the lessons and are trying to fix the problems.”331

The remainder of this Conclusion will assess the future of the Basel Process from a global governance perspective. This assessment will include the tension between the
initiatives of individual states and the global Basel III proposals of the expanded G20 as efforts to recover from the Global Financial Crisis play out in the years ahead.

Regulation after crisis is a constant in the history of finance. In the United States, the creation in 1913 of the Federal Reserve System (acting as lender of last resort) was a response to the Panic of 1907, and the creation of the Federal Deposit Insurance Corporation in 1933 came in response to the banking failures of the early 1930’s.\(^{332}\)

For those who believe that the Global Financial Crisis requires a substantial modernization in the governance of global finance (itself a controversial opinion), the modifications need to be global rather than applying to one country alone. Nevertheless, how can a global solution be crafted to “toughen up capital requirements” when there are so many different positions to reconcile? For instance, it might be argued that having their capital requirements lowered since they have followed conservative practices should reward some of the more cautious European countries, like Germany. On the other hand, those guilty of extremely risky and highly leveraged practices surely should have their capital requirements raised\(^{333}\)

In the wake of the recent financial crisis, many financial reforms are being debated. In order to effectively regulate banks and contain financial risks inherent in global capital markets, regulators need to monitor the trading activity banks, hedge funds, and other investors in a variety of financial instruments, particularly financial derivatives. However, if the financial industry uses its lobbying effectiveness to prevent the regulation of new financial derivatives (such as credit default swaps), then obviously the
regulators cannot prevent the over-leveraging of positions taken in over-the-counter financial instruments.

There are disagreements, particularly between the banking industry and the committee, on the specific approaches being taken to achieve this purpose. The industry argues that the committee is going overboard in many areas and doing so in ways that will significantly, and unnecessarily, raise the cost of providing loans and other banking services. Some of the key areas of discord are net stable funding ratio, higher capital ratios, use of a leverage ratio, elimination of softer forms of capital, and exclusion of some balance sheet items from capital.

There is a long list of reforms included on the menu of reforms in the wake of the Global Financial Crisis. Should bank-to-bank transactions be centralized towards clearinghouses where financial risks are visible to regulators and the markets? Should risk management methodologies like Value at Risk (VaR) be refined to take into account more extreme market conditions? Should additional capital be required for positions in the “trading book” as opposed to the long-term “investment book”? How should capital requirements be reevaluated for credit default swaps which shift financial risk completely out of the banking sector and into the insurance sector?

The struggle between stability and competitiveness continues as strongly as ever. Led by the Institute of International Finance (IIF, discussed in Chapter 3), the largest banks argue that the higher capital ratios could slow global economic growth. The IIF banks in the three leading financial systems — the United States, the European Union and Japan — would need to raise $700 billion of common equity and issue $5.4 trillion of long-term
debt from 2010 to 2015 in order to meet the Basel capital and liquidity requirements that are likely to be part of the international regulatory overhaul. The institute further estimates that, for the United States, the capital requirements would reduce growth in its gross domestic product by 2.6 percent by 2015. The impact would not be as bad in Japan, with a 1.9 percent restraint on G.D.P., but it would be worse in Europe, with a 4.3 percent hit. As Ackermann ominously put it when he presented the IIF’s report to the Basel Committee: “There is no question that increased costs to banks of core capital and funding will have to be largely passed along, which inevitably will take a macroeconomic toll.”

The debate continues over the future of the Basel II approach. There are those who want it to succeed because of the years of effort devoted to it. Its opponents feel that it is “anti-competitive” and “too complex” and should fail because it is not enforced consistently and is constantly under revision. The perennial questions of Global Governance and the Basel Process remain. Even in the aftermath of the GFC, which was at its core a crisis over capital adequacy (or the lack thereof), participants in the Basel Process oppose efforts to prevent a recurrence of the same set of circumstances.

The challenge remains: How can detailed technical arcane regulations be crafted on a supranational level with the “proper balance” between financial stability and “level playing fields,” without creating too many competitive disadvantages?

The traditional state-centric solution does not meet this goal because each state legislates to maximize its own national advantages without attempting to take account of the impact on other nations. There is a trade-off between regulations drawn up in secret by
technocrats and regulations publicly debated in national legislatures. Those drawn up in secret may have been more finely crafted, possess greater internal coherence, and the potential for higher welfare-maximizing value.339

The problem of reaching consensus on the way forward towards the harmonization of capital adequacy standards is perhaps even more insurmountable because of the diminished economic and political stature of the United States and the rise of the emerging market economies that are not as dependent on the wealthy nations for the flow of international capital.

While the United States maintained its “structural power” in the global economy, the question was moot because it was assumed that the US would act in the interest of an “open international trading system” so as to maximize the welfare of all countries participating in the global system. This was boiled down to a set of maxims referred to as the Washington Consensus and later the revised Post-Washington Consensus. Because of the GFC, the Basel Process has been thrown open to the G20 rather than the G8.340

This section will discuss the specific items on the Basel II agenda have been addressed and those that have been left alone.341 What lessons from the Panic of 2008 and Global Financial Crisis have been incorporated into Basel III?342 What systemic weaknesses have been left unaddressed? How has the need for “macro-prudential supervision” been addressed? What about the need to provide “resolution authority” to deal with “too big to fail” banks when they face crises?343

There is a need to add requirements to institute minimum levels of cash-ready liquidity (in addition to capital) to prevent another “freeze up” of the credit markets. The wisdom
of allowing large banks to model their own capital requirements and rely on “market
discipline” (Pillar 3) is in question. There is still a demand to assign adequate supervisory
responsibilities for institutions that cross many borders. Supervision for futures and the
markets for other derivatives are still inadequate.


The Basel Committee and the Financial Stability Board (FSB) is coordinating the
international policy response to the GFC and undertaking an official macroeconomic
impact assessment jointly with the Bank for International Settlements and the
International Monetary Fund.

With the Basel III iteration of the Basel Process, the Basel Committee has shown its
intention to require that banks strengthen their Tier 1 capital and to hold sufficient
liquidity assets to survive a short-term credit crisis while reducing their dependence on
short-term funding. However, Nout Wellink, the chairman of the Basel Committee and a
member of the European Central Bank has stated that during the current fragile recovery
phase from the GFC, banks are not in a position to make drastic changes. In the delicate
jargon of central bankers, Wellink has remarked: “We will ensure the banking sector can
move to the new standards through earnings retention and reasonable capital raising.
Where there are trade-offs, these should go in the direction of giving banks the time to
reach the new standards instead of watering down the standards themselves.”

If banks realize that under Basel III they have excess capital, then may be encouraged to
acquire other banks, thus creating larger and more concentrated potential sources of
financial risk in the global economy. Since the imposition of capital charges for
systemically important banks (those that are “Too Big to Fail”) has not been incorporated in Basel III, this may become a *perfect example of an unintended consequence* of Basel III.345

**8.2.1.1. “Crowded Trades” Guarantee Future Financial Panics**

Recall from Chapter 1 that there are three types of bank capital: **Economic capital** is that which is demanded by investors and counterparties and chosen by shareholders as appropriate for the bank without regard to regulation. **Regulatory capital** is the minimum that banks *must* maintain by regulation. **Actual capital** is the capital chosen by bank shareholders taking into account regulatory constraints.

Assume that banks maintain the appropriate level of economic capital because it is in their self-interest to have an adequate protection against risk of expected losses on their assets and investments. Banks seek to **minimize regulatory capital** above their perceived correct level of economic capital since every dollar left on reserve is a dollar that cannot be profitably invested. Since the Basel capital adequacy regimes are based on the risk-weighting, or pricing, of financial risks, the greater the risk in a given investment or position, the more capital the bank should be required to hold. Mispricing financial risk means not requiring adequate capital.

The fatal flaw in the opinion of “free market” economists is that, if financial risks are underpriced by the regulators, then banks will discover that mispricing and rush to take exactly those positions. In other words, capital requirements create the unintended consequence of creating incentives that result in “crowded trades” and hence contribute to the concentration of systemic risk.
The risks become mispriced as more investors exploit those low capital requirements, increasing the financial risks because so many more participants have taken exactly the same positions in the market. Thus, mispriced capital requirements also add to a false sense of security among the regulators, legislatures, and the public.

This was particularly the case in the role of CDO’s on subprime mortgage that triggered the GFC. As we saw, the instruments were given AAA ratings, thereby lowering the capital requirement on holding those investments. When it became obvious that banks were holding onto the AAA-rated portions of CDO’s, the so-called “super senior” tranches, the trade became “crowded” in that all market participants sought to “run for the exit” and no buyers (except the Federal Reserve Bank) could be found for those securities.346 “Crowded trades” thus guarantee future financial panics.347

“If one believes, to cite an example, that the Crisis was caused by unsustainable increases in property values and poor mortgage underwriting, Basel II is off the hook: Basel II does not address valuation and underwriting standards.348

8.2.1.2. The Macroprudential Provision of Basel III: Global Keynesianism?

The relationship between macroeconomic policy coordination and macroprudential banking, so-called macroprudential supervision, is very interesting from a Global Governance perspective. It implies that the Basel Committee will attempt to exercise the power to regulate domestic economies, a function which is normally closely guarded by the state itself.349 This does not even presume that there will be macroeconomic policy coordination between heads of state.350 One Australian finance professor captures the reaction of many non-central bankers to the proposal that macroprudential supervisory
powers be given to the BIS or any other global body: “It is the job of a banking regulator to ensure a sound banking system…. Unless, and until, there is proper democratic accountability over their decisions, banking regulators should not … be a party to macroeconomic decision making, such as the tightening or loosening of credit.\(^3\)\(^{51}\)

As Schooner and Taylor point out, it is hard to imagine that bank regulators will be able to correctly call turns in business cycles, so as to provide more capital during periods of stress and less during expansions.\(^3\)\(^{52}\) If the regulators get the cycle wrong, changes in capital might be procyclical and exacerbate the problem rather than ameliorate it. Secondly, they explain, countries experience business cycles at different times. Finally, since there are multiple cycles at work in the global economy, how can a bank with operations in the United States, Europe, and Japan be subjected to countercyclical changes in regulatory capital if that bank is experiencing three different business cycles?

Thus, even though the Basel Committee seeks to incorporate lessons learned from previous financial crises, even the obvious need to replace procyclical responses with countercyclical solutions is an open topic for debate.

Why was the Basel Capital Accord so irrelevant to avoiding the crisis of capital adequacy that resulted from the collapse of the housing bubble in the US in 2007? Was the crisis of capital adequacy an unintended consequence of the attempt to harmonize international standards embodied in the Basel Capital Accord?

Given the decades of “sunk costs” in the Basel process, will the complete implementation of Basel II slow global economic growth at a time when the “real economy” is in desperate need of cheap and abundant credit? What viable alternatives to the Basel
process have been proposed? As the number of participants increases through the G20, will the Basel process become even more unwieldy and thus its irrelevance to the next global financial crisis?

Since the recovery from the GFC got underway, officially in the summer of 2009, academic discussion has turned to understanding the causes of the crisis. This list includes whether regulations imposed by Basel II left the financial system severely undercapitalized; the role of credit rating agencies in failing to warn of the risks inherent in new financial products; the procyclicality of minimum capital requirements; and the methodologies for valuing securities which are not traded on open exchanges and in very limited volumes.353

8.2.2. Other Positive Lessons Learned about Business Practices

8.2.2.1. Bank Supervisors Should Seek Simpler Capital Standards

Matthews argues that regulatory capital should not be seen as a primary line of defense for banks against future market meltdowns despite the urgings of the G20.354 Moreover, the 8 percent of risk-weighted assets floor of Basel I that proved inadequate to cushion the US from the financial market meltdown in 2008 should not be raised as it was, from the beginning, an arbitrary number. Thirdly, Matthews maintains that bank supervisors should seek simpler capital standards that can serve as a check against sophisticated internal risk measurement models that “are discredited as highly procyclical and prone to abuse.”

For the past 20 or so years, the global financial community has tried to create a common minimum regulatory capital standard for banks. The result has been a complicated framework that is not enforced
Policymakers, she continues, “technocrats and bankers… have sunk substantial political capital, compliance and IT costs into Basel II [and so] continue to cling to the framework”. Acknowledging this reality now will help avoid the harmful effects that higher regulatory capital requirements are likely to have on the access to credit for credit-worthy customers.

“Starting in 1998, a committee of global regulators set out to design a set of modern risk controls eventually promulgating the Basel II capital requirements. Even though this exercise excluded insurers, broker-dealers and hedge funds, concentrating exclusively on banks, it still chewed up six years and ended in abject failure…. But despite fifteen years of having the system in place, and several years spent trying to improve it, it had all come to naught — the very crisis the Basel Accord was designed to prevent happened anyway.”

8.2.2.2. Dodd-Frank Act’s ban on external credit rating agencies

The Dodd-Frank Act prevents US regulators from relying on credit ratings in any regulation, thus calling into question the basis on which capital weightings have been determined for the past three decades of the Basel Process. This system links the risk-weighting of a company to its credit rating from the rating agencies (Standard & Poor’s, Moody’s). The European Parliament is also concerned with Basel III for similar reasons. On October 7, 2010, the European Parliament passed a resolution pressing the European Commission to determine whether Basel III would give U.S. banks competitive advantages over European-based banks.

European representatives led by Germany and joined by Japan opposed the suggested external ratings based system. As mentioned in the discussion of Basel II above, in 2002...
German Chancellor Schroeder threatened to take the Germans out of the Basel II negotiations unless the capital treatment for SMEs was fixed in accordance with German demands.\textsuperscript{359}

The issue was decided in Germany’s favor at the time. In Basel III, the issues have been reopened.\textsuperscript{360}

8.2.2.3. Controlling Originate-to-Distribute: Keeping some “skin in the game.”

A possible compromise, known as “retention,” would allow use of off-balance sheet entities, but require that some portion of a securitized offering by banks remain on the bank’s books to insure that the bank had some “skin in the game.”\textsuperscript{361}

8.2.3. Global Governance versus National Governance Initiatives

How effective will the United States be in advancing the Basel III agenda considering that the United States has still not fully implemented the Basel II agreement? Former Comptroller of the Currency, Eugene Ludwig, notes that many bankers are worried about a repeat of the decade of “horsetrading” it took to thrash out Basel II. The United States will also face stiff resistance from the EU on wholesale reform of Basel II simply because the EU did adopt it into law in 2007 while the United States is still debating it domestically. As mentioned in the section on controversies in the Global Governance literature, global financial governance is complicated by parallel regulatory negotiations and regimes especially between the United States and European Union. The EU is making some changes, but there is no sign of an appetite in Europe for radical reform. “Basel III? No way,” Jose Maria Roldan, the Spanish chairman of the Basel Committee’s
standards implementation group said in June 2010. “Our priority is that we strengthen Basel II and make sure it’s truly implemented.”

8.2.3.1. The US Response to the Panic of 2008 Violated Norms of Post-Crisis Recovery

The GFC emanated from the United States, not an emerging market economy like Thailand in 1997. In order to rescue the American economy, the United States has violated the guidelines imposed on emerging market economies seeking assistance from the IMF after financial catastrophe strikes. This undermines the legitimacy of the American role in laying down sets of guidelines like the “Washington Consensus.”

8.2.3.2. German reluctance to adopt Basel III before the United States

As discussed above, the United States became so bogged down in domestic negotiations between core and non-core banks that Basel II was not fully adopted before the Global Financial Crisis. As a result, the German banks are very reluctant to adopt the Basel III proposals being discussed in the wake of the crisis, out of concern that in so doing they would put themselves at a competitive disadvantage.

Just as there are internal politics in the United States between the international money center (“core”) banks and the domestic smaller community (“non-core”) banks, so in Germany there is tension between the commercial banks and the public-sector institutions called landesbanks. The landesbanks are usually owned by German states and the regional sparkassen, or saving banks, which tend to have close ties to local politicians. Like American community banks, the landesbanks fiercely defend their independence, arguing that Landesbanks are vital to the German economy, providing nearly a quarter of
the lending requiring by German business. German commercial bankers, on the other hand, welcome a leaner landesbank sector and resent competition from these institutions that they believe face less pressure to be profitable.

Pressure could also come from the proposed Basel III rules governing the capital that banks are required to hold in reserve. The stress tests undertaken by the European Union in the wake of the GFC have forced the German banking industry to take a hard look at their potential weaknesses. Basel III proposals are bringing the issue to a head if those proposals force the landesbanks to raise more capital than can be provided by their state owners.

As a result, neither the German government nor the central bank has the power to require the landesbanks to correct their capital adequacy positions. Like the lobbyists for the American community banks, the Association of German Public Sector Banks argues, “You can’t just say we’re getting rid of them all or throwing all in one pot. That would lead to shrinkage of credit, which is not what you want right now.” The Basel Committee maintains a permanent subcommittee on the definition of capital. To see why this debate persists, one should look at the position taken by Germany in the current negotiations over Basel III.364

To the United States and many other countries, a bank’s core capital should come from common equity and retained earnings. Any other sources of capital are regarded as unreliable in times of financial stress. The Basel committee defines core capital as only equity and retained earnings and does not take into account other capital contributions on which the banks rely.
Germany, on the other hand, insists that other sources of capital be considered eligible to be counted as core capital. Germany's cooperative banks have expressed opposition to the proposed rules because their savings and cooperative banks rely on deposits and thus have no real equity. The cooperative banks hold as much as half of Germany’s bank assets.

German officials balked at the new rules aimed at shoring up the global banking system, referred to as Basel III, saying the rules would unfairly penalize the thousands of savings and cooperative banks that provide financing for many of the small and medium-size businesses that power Germany's economy. Germany cited the nuances of financing for small and medium sized firms that are the backbone of Europe's largest economy: "We have a very specific problem in Germany which no other country has -- our savings banks and cooperative banks…they finance the Mittelstand [small and medium-sized enterprises] which do not have access to capital markets". 365

Unlike the private banks and Landesbanks, they were not highly exposed to the mortgage-backed securities originated in the United States that were at the root of the financial crisis. They are also analogous to America’s non-core community banks in that they lend primarily to local firms in their region.

In Germany, the savings banks (known as Sparkassen) and the Landesbanks (state-sector regional banks) utilize “silent participations” as part of their capital positions which are nonvoting shares, including government loans, that buffer bank capital positions and often come with a set date for repayment to the investor”. 366 The Basel Committee excludes them from banks' Tier 1 capital, because “silent participations” do not absorb
losses as long as a bank is still in business. Unless they are reinstated in Basel III, German banks could be forced to raise billions of Euros, potentially resulting in a major shortfall to the loans required by German business. Germany had received full recognition of silent participations until Basel II and now must renegotiate their status under Basel III.\textsuperscript{367}

French banks are highly critical of Basel III proposals. They argue that French banks should not be penalized by more stringent Basel III capital requirements since they were hardly affected by the recent financial crisis\textsuperscript{368} The French are also opposed to the use of fair value accounting because, in their view, it is inappropriate to use mark-to-market accounting.\textsuperscript{369}

\textbf{8.2.3.3. Comparisons between Basel III and Dodd-Frank}

Some have noted that there is an inherent conflict between Dodd-Frank and Basel III. The latter is a far superior piece of regulatory reform since it is the product of the Basel Committee while “the rushed Dodd-Frank bill will make US banks uncompetitive relative to international banks, restricting the volume of credit and increasing the costs of borrowing, preventing the V-shaped recovery required to attain full employment.”\textsuperscript{370}

In the final analysis, many countries are still implementing Basel II rules while the debate on Basel III continues. Similar to the two preceding accords, these international agreements do not directly bind on a national level. As Went comments, unless there is the political power to enact legislation that incorporates these proposals into the national regulatory framework, these rules may remain toothless.\textsuperscript{371}
8.2.4. Implications of Expansion from Basel Committee to the G20 / FSB

Going to the heart of the “Global Governance dilemma” is the legitimacy of the institutions making regulations without any input from the countries that are not represented on the Basel Committee.

As mentioned in the discussion of regulatory capture and banking supervision in the emerging markets, the Basel Process was not initially intended for the non-G10 economies. Basel I, with only 12 members in the 1980’s, took less than a year to hammer out as an agreement and created an international standard for banking regulation that has been voluntarily adopted by approximately 120 nations.

Why were the “emerging markets” so eager to harmonize the banking regulations with those of the industrially and financially advanced nations? The recognition of weaknesses or outright crises in developing country banking systems encouraged the World Bank and the IMF to adopt higher capital requirements. Basel I was a convenient benchmark that enabled industrial country regulators to advance the use of “best practices.” Pressure on a number of developing countries also came from the international rating agencies.

One of the missions of the IMF and World Bank is financial supervision including the enforcement of the Basel Core Principles. Egregious instances of non-compliance with international standards can trigger sanctions by and from international organizations and financial institutions. Compliance with international standards is often the basis upon which loans are granted by the IMF and the World Bank.
8.2.4.1. Basel and the Democratic Deficit

In the literature on Global Governance, the Basel Process is viewed as suffering from a “democratic deficit” in that those not party to the Basel Committee must accept regulations on which they were not consulted. Alternatively, sometimes they are granted “supervisory discretion” if the regulations would unacceptably affect their economies. How can such an agreement based on international “soft law” be implemented by so many states with so little input from those nations? How can the final product of the Basel Process take account of a wider range of interests than just the “rent-seeking demands of private financial firms” and be made accountable to the broader public?

8.2.4.2. New place on the world stage for the G20 / FSB as a result of the GFC

Because of the Panic of 2008, the G20 has stepped into the Basel Process as a full participant and the venue for proposing a revision to Basel II has shifted from the Basel Committee to the Financial Stability Board. As U.S. Treasury Secretary Timothy Geithner acknowledged, the Financial Stability Board instead of the Basel Committee will develop Basel III. What does the relocation of negotiations from the Basel Committee to the Financial Stability Board imply for the future harmonization of international capital adequacy standards in the banking industry? In international political and economic terms, what does the enlarged role of the G20 mean for the Basel Process? While the expansion of participants should help to reduce the “democratic deficit,” what will be the impact on the United States?
8.2.4.3. Will the G20 Tip the Balance between Stability and Competitiveness?

This “democratic deficit” is not simply an academic issue because rules can raise the cost of doing business in some countries and put them at a permanently competitive disadvantage vis-à-vis the members of the Basel Committee. Emerging economies suffer the most from reliance on credit rating agencies since they pay little or no attention to their economies and thus raise the cost of international capital that looks very risky indeed.\textsuperscript{380}

In fact, the impact of the Basel Accords on emerging market economies is double-edged. On the one hand, it encourages potential investors who may be reassured that global financial standards have been met and given the approval of the Basel Committee, the IMF, the World Bank, or other international financial regulators. On the other hand, adhering to the Basel standards increases the cost of funds desperately needed for development.\textsuperscript{381}

Other features of the Basel Accords that clearly create competitive disadvantages for emerging market economies are likely to be opposed by the G20. Emerging market nations in the G20 may be likely to shift the emphasis of the harmonization of capital adequacy regulations from “safety and soundness” to “economic competitiveness.” This is seen in the introduction of the new Countercyclical Capital Buffer that will only begin to be phased in five years from now.

However, this proposal is highly controversial since it presumes that a transnational regulator (BCBS or FSB) has the authority to overrule the monetary powers reserved to independent central banks when recessionary economic conditions are forecast in
individual nations (or globally). This may weaken the entire edifice of financial regulation if the powers of the BCBS or FSB are directly challenged.

8.2.4.4. The “Ratification Requirement” and the Democratic Deficit

Widening the focus from the expanded role for the G20, because of the GFC, the financial regulatory process has become politicized to an unprecedented extent particularly in the countries that have experienced massive public bailouts of private institutions. As Helleiner notes, “previously obscure topics such as the regulation of credit default swaps suddenly become the subject of legislative debates and lively public discourse… [imposing on regulators] much greater constraints on their ability to negotiate new international rules or delegate sovereignty to international institutions.”

As a result of more countries and individuals participating in the discussion over financial reform, we can expect the debate to become more contentious than ever before simply because the measure of trust and confidence placed in financial regulators has been significantly diminished. As Helleiner argues, we can predict a more open “ratification requirement” in operation, making it very difficult for regulators to “conduct themselves in a relatively opaque and seemingly apolitical environment”. Recall that there is precedent for political backlashes seen in 2002 when the German Chancellor threatened to withdraw Germany from Basel II given fears over the “SME issue.” While earlier in the Basel Process, governments could leave the negotiations to the financial specialists in the bureaucracy, in the future the negotiations are likely to involve finance ministers and even heads of state—not to mention affected financial institutions, lobbyists of all stripes, and an ever-widening attentive public.
Intense state interest in the reconstruction of the global financial system in the wake of the Crisis has spirited away much of the policy debate from the technocrats at the Basel Committee and repositioned it at the intergovernmental level. That level now includes many more governments, and widening participation will likely entail greater diversity in positions and more compromises and/or stalemates. Ultimately the wider process may undercut the support for the future of improved governance of the global financial system and leave national economies and societies more at risk of future unpleasant surprises. However, recalling the discussion of the libertarian critique of Global Governance, perhaps this is a benefit for the ultimate stability of the world financial system and therefore something to be welcomed.

In conclusion, the “structural power” of the United States to help create a new international financial regulatory order has been severely diminished because of the GFC. Moreover, the overall role of the Basel Process may have been fatally weakened if the US decides to concentrate on national rather than transnational solutions. One of the legacies of the GFC may well be that a more decentralized international regulatory order emerges in which national and regional authorities set their own regulatory priorities. This should not be overstated, however, since Basel II allowed for so many instances of “supervisory forbearance” that it was never an all-inclusive international standards regime. The G20 has become the most significant forum for the design of the post-Crisis international financial system as well as the terms of its regulation. Indeed, the emergence of the G20, and its displacement of the G8, is one of the most important developments resulting from the Crisis. Basel II may therefore lose its pretense as the exclusive or even primary forum for guiding the global banking system.
## Abbreviations, Terms and Concepts

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>ABS</td>
<td>Asset-backed security: a security whose value and income payments are backed by a specified pool of underlying assets and “securitized” to be sold to investors.</td>
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| Actual capital | The capital chosen by bank shareholders taking into account regulatory constraints.  
Contrast to economic capital and regulatory capital (see below). |
| Basel II     | The “new capital adequacy framework” issued by the BCBS in 1999.                                                                                  |
| Basel II advanced approaches | **Core banks** (those that meet the requirements in terms of asset size and foreign exposure for mandatory adoption of the Basel II advanced approach) use the Foundation or the Advanced Internal Ratings-based (A-IRB) approach for calculating risk-based capital requirements and the advanced measurement approaches (AMA) for operational risk.  
**Non-core banks** continue using a modified standardized approach. |
<table>
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<tr>
<th>Basel IA</th>
<th>To avoid imposing the heavy costs on the small “non-core” banks of developing their own risk models, the U.S. regulators agree to try to</th>
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<tbody>
<tr>
<td>Basel Accords</td>
<td>For a glossary of technical terms related to the Basel Accords, see “The New Basel Capital Accord: Glossary of Terms.”</td>
</tr>
<tr>
<td>Basel Core Principles</td>
<td>A document issued by the BCBS to be “used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to be done to achieve a baseline level of sound supervisory practices.”</td>
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<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision (“Basel Committee”). The Committee's members are Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.</td>
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<tr>
<td>BIS</td>
<td>Bank for International Settlements: “an international organization which fosters international monetary and financial cooperation and serves as a bank for central banks.”</td>
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<tr>
<td><strong>BISTRO</strong></td>
<td>The financial product that became known as a “collateralized debt obligation”. Cryptically titled “<strong>Broad Index Secured Trust Offering</strong>” by its innovators, Blythe Masters and Bill Demchak (key members of JP Morgan’s credit derivatives team). Also known as: “<strong>BIS</strong> (i.e. Bank for International Settlements) <strong>Total Rip-Off</strong>”. “The Bistro concept had pulled off a dance around the international banking rules” [i.e. Basel I] 398</td>
</tr>
<tr>
<td><strong>Capital Conservation Buffer</strong></td>
<td>Introduced in Basel III to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress.</td>
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<tr>
<td><strong>CDO / CMO</strong></td>
<td>Collateralized debt obligations: a type of structured asset-backed security (ABS) whose value and payments are derived from a portfolio of fixed-income underlying assets. 400 CMOs (collateralized mortgage obligations) are a type of CDO.</td>
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<tr>
<td><strong>CLO</strong></td>
<td>Collateralized loan obligations: a type of collateralized debt obligation where payments from multiple middle sized and large business loans are pooled together and passed on to different classes of owners in</td>
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<td>Term</td>
<td>Definition</td>
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<tr>
<td>Contingent Capital</td>
<td>A special kind of debt that automatically converts to common stock when the firm's regulatory capital gets depleted becoming available during a crisis to stabilize a bank and bolster its solvency.(^{402})</td>
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<tr>
<td>Countercyclical Capital Buffer</td>
<td>Introduced in Basel III: common equity or other fully loss absorbing capital which will be phased in from January 2016 to enable banks to increase lending to counter business cycle recessions.(^{403})</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit Default Swaps: explained above in Section 7.2.6.1. (“BISTRO, Credit Default Swaps and the Derivatives Dream&quot;).</td>
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<tr>
<td>CPs</td>
<td>Consultative Papers issued by the Basel Committee to facilitate dialogue between the banking community and the banking regulators.(^{404})</td>
</tr>
<tr>
<td>CRD</td>
<td>Capital Requirements Directive: enacted by the European Parliament on Sept. 28, 2005 requiring each of its banks and investment firms to adopt the Basel II standards starting in January 2007.(^{405})</td>
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<tr>
<td>Credit limits</td>
<td>The net exposure allowed by the credit risk analysts of a financial institution to a specific counterparty, industry or location. Creates an incentive to remove exposures from the balance sheet.</td>
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<tr>
<td>Term</td>
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<td>States by improving accountability and transparency in the financial system, to end &quot;too big to fail&quot;, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.&quot;406</td>
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<tr>
<td>&quot;Double gearing&quot;</td>
<td>A Japanese banking practice whereby “the same capital is used simultaneously as a buffer against risk in two or more legal entities (banks and insurance companies)”407</td>
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<tr>
<td>Economic capital</td>
<td>The amount of capital demanded by investors and counterparties and chosen by shareholders as appropriate for the bank without regard to regulation.408</td>
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<tr>
<td>FASB</td>
<td>The Financial Accounting Standards Board: a private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles (GAAP) within the United States.409</td>
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<tr>
<td>FBSEA</td>
<td>Foreign Bank Supervision Enhancement Act of 1991: gave additional powers to the Federal Reserve to supervise foreign banks operating within the U.S. to approve a new subsidiary, branch, agency, or representative offices of foreign banks in the U.S. and to close foreign banks operating in the U.S. Provided that only foreign banks with access to the FDIC can accept consumer deposits.410</td>
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<tr>
<td>FCIC</td>
<td>United States Financial Crisis Inquiry Commission. A ten-member commission appointed by the United States government with the goal</td>
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of investigating the causes of the financial crisis of 2007–2010.411

<table>
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<tr>
<th>Acronym</th>
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<tr>
<td>FSB</td>
<td>The Financial Stability Board: established in April 2009 and empowered by the G20 to replace the Financial Stability Forum “with a stronger institutional basis and enhanced capacity” and a broadened mandate to promote financial stability.412</td>
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<tr>
<td>FSMA</td>
<td>Financial Services Modernization Act of 1999 (or The Gramm–Leach–Bliley Act): repealed part of the Glass–Steagall Act of 1933 opening up the market among banking companies, securities companies and insurance companies. 413</td>
</tr>
<tr>
<td>G7 / G8</td>
<td>Refers to the member states and the annual summit meetings of the following states: Canada, France, Germany, Italy, Japan, Russia, Great Britain, and the United States. Their respective ministers for finance, foreign relations, and the environment also meet under the umbrella of the G8. The European Union is represented within the G8, but cannot host or serve as chair.414</td>
</tr>
<tr>
<td>G10</td>
<td>The Group of Ten = The G7 + Belgium, Netherlands, Sweden, and Switzerland. The Bank for International Settlements (BIS), European Commission, IMF, and OECD are official observers.415</td>
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</table>
| **G20** | The “Group of 20” is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, Great Britain, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United States. The European Union is the 20th member of the G20.  
[416] |
| **G30** | The think-tank (consisting of high-level private sector representatives, public officials, and academics) that played a leading role in promoting Basel II.  
[417] |
| **GAAP** | Generally Accepted Accounting Principles: the standards, conventions, and rules that accountants follow in the preparation of financial statements which allow for an "apples to apples" comparisons of corporations and other business entities. Many countries use or are converging on the International Financial Reporting Standards (IFRS).  
[418] |
| **GFC** | Global Financial Crisis (events surrounding the “Panic of 2008”). |
| **GGT** | Global Governance Theory: the body of literature dealing with “the increasing challenge of managing issues … beyond the geographical reach of individual states to address on their own… [and also to] the totality of discernible polity authority domains in the world.”  
[419] |
<p>| <strong>GLB</strong> | Gramm–Leach–Bliley Act (see FSMA above). |
| Harmonization | “Adjustment of differences and inconsistencies among different |</p>
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<tr>
<th><strong>(of regulatory capital)</strong></th>
<th>measurements, methods, procedures, schedules, specifications, or systems to make them uniform or mutually compatible.(^{420})</th>
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<tr>
<td><strong>Hybrid capital</strong></td>
<td>“a form of debt that has been substituted for equity… such as preference shares, that are not pure equity but have traditionally been deemed close enough to it to count towards a bank's tier one capital ratio - the key measure of financial strength.” (^{421})</td>
</tr>
<tr>
<td><strong>IASB</strong></td>
<td>The International Accounting Standards Board: an independent, privately funded accounting standard-setter based in London, responsible for developing International Financial Reporting Standards.(^{422})</td>
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<tr>
<td><strong>ICAAP</strong></td>
<td>Internal Capital Adequacy Assessment Process: Under Pillar 2, the banking agencies expect banks to implement and continually update the fundamental elements of a sound ICAAP, that is, identify and measure material risks, set capital-adequacy goals relating to risk, and ensure the integrity of internal capital-adequacy.(^{423})</td>
</tr>
<tr>
<td><strong>IFRS</strong></td>
<td>International Financial Reporting Standards: The Standards, Interpretations and the Framework adopted by the International Accounting Standards Board (IASB). IFRS are used in more than 113 countries around the world… The US is slowly but progressively shifting from requiring only US GAAP to accepting IFRS and will most likely accept IFRS standards in the long term.(^{424})</td>
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<tr>
<td><strong>IIF</strong></td>
<td>Institute of International Finance: “the world's only global association of financial institutions. It was created by 38 banks of leading industrialized countries in 1983 in response to the international debt crisis of the early 1980.”[^425]</td>
</tr>
<tr>
<td><strong>IR</strong></td>
<td>The academic discipline of International Relations.</td>
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<tr>
<td><strong>IRB</strong></td>
<td>The internal ratings-based approaches in the Basel II Framework.</td>
</tr>
<tr>
<td><strong>ISDA</strong></td>
<td>The International Swaps and Derivatives Association, Inc.: the self-regulatory organization that “has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.”[^426]</td>
</tr>
<tr>
<td><strong>IOSCO</strong></td>
<td>The International Organization of Securities Commissions: an association of organizations that regulate the world’s securities and futures markets.[^427]</td>
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<td><strong>LCFI</strong></td>
<td>Large and complex financial institutions (see TBTF).</td>
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<tr>
<td><strong>Leverage</strong></td>
<td>As used in this dissertation, the ratio between capital held by a financial institution and the amount of its outstanding investments. The higher the leverage, the higher the systemic risk since there is less capital to cushion the firm if the value of those investments changes in a direction not expected by the firm.</td>
</tr>
<tr>
<td><strong>Leverage Ratio</strong></td>
<td>The capital-to-assets ratio (core capital ÷ total assets). A <em>simplified</em></td>
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<tr>
<td><strong>alternative to the sophisticated risk modeling embodied in the Basel II approach that does not account for market values, riskiness of assets, or off-balance-sheet activities.</strong></td>
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<tr>
<td><strong>Liquidity requirements</strong></td>
<td>The daily process by which banks monitor and project cash flows to meet obligations when they come due without incurring unacceptable losses (contrast solvency).</td>
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<tr>
<td><strong>LCR</strong></td>
<td>Liquidity Coverage Ratio. The new liquidity regime proposed in Basel III includes a liquidity coverage ratio requirement and a net stable funding ratio requirement. The LCR is designed to moderate the practice of financing assets with very short-term funds. Its purpose is to encourage banks to maintain an adequate funding cushion for periods up to 30 days of extreme stress in credit markets. It is not scheduled to come into force until 2015.428</td>
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<tr>
<td><strong>Macroprudential supervision</strong></td>
<td>“The goal … is to reduce the probability of distress for the entire financial system when that distress has the potential to adversely impact the real economy.”429</td>
</tr>
<tr>
<td><strong>MAG</strong></td>
<td>The Macroeconomic Assessment Group: The joint effort by the FSB, BCBS, and IMF to assess the macroeconomic impact of the transition to stronger capital and liquidity requirements under Basel III.430</td>
</tr>
<tr>
<td><strong>Mark-to-market accounting</strong></td>
<td>Carrying the value of securities on the balance sheet at current market value rather than the historic trade price.</td>
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<tr>
<td>Market Risk Amendment</td>
<td>Developed in response to criticisms that Basel I lacked sensitivity to risk (&quot;granularity&quot;), this 1996 amendment allowed banks to use value-at-risk models (VaR) in making internal calculations of risk.</td>
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<tr>
<td>Micropolicy</td>
<td>Refers to the role of central banks as guardians of the financial markets: regulation of national banks; smooth functioning of national payments systems; and supervision of individual financial institutions (control over microprudential risk).</td>
</tr>
<tr>
<td>Microprudential supervision</td>
<td>The use of tools to reduce the frequency and impact of crises at individual systemic institutions.</td>
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<tr>
<td>MCR</td>
<td>Minimum Capital Requirement (MCR): under Pillar 1, the lowest level of capital below which a firm must not fall to remain solvent.</td>
</tr>
<tr>
<td>Minority Interests</td>
<td>Counting capital held in affiliates. Basel III originally proposed a ban on banks counting capital held in affiliates as part of their own holdings. This triggered fears of a freeze in acquisition of minority stakes or sell-offs to avoid the need for extra capital. Banks will now be able to include capital from minority-held companies up to a certain threshold.</td>
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<tr>
<td>Mittelstand</td>
<td>Small and medium-sized enterprises especially in Germany, Austria and Switzerland (see SMEs).</td>
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<tr>
<td>Moral hazard</td>
<td>Occurs when an individual or institution does not take the full responsibility for its actions in the belief that another party (such as a</td>
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<tr>
<td>NRB</td>
<td>Net regulatory burden: “the difference between the costs of regulations and the benefits for the producers of financial services.” 435</td>
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<tr>
<td>“A new capital adequacy framework”</td>
<td>Title of the Basel II document issued in 1999: “This new capital framework consists of three pillars: minimum capital requirements, a supervisory review process, and effective use of market discipline.” 436</td>
</tr>
<tr>
<td>NSFR</td>
<td>Net Stable Funding Ratio: A Basel III proposal designed to stop banks financing long-term assets with overnight money (the “Bear Stearns problem”). Relates the long-term and stable sources of funding to improve resiliency to short-term liquidity shocks. 437 “A contentious proposal, fiercely opposed by the banks” which has been pushed back to 2018 implementation. 438</td>
</tr>
<tr>
<td>NPR (or NPRM)</td>
<td>Notice of proposed rulemaking: “a public notice issued by law when one of the independent agencies of the United States government wishes to add, remove, or change a rule or regulation as part of the rulemaking process. It is an important part of United States administrative law which facilitates government by typically creating a process of taking of public comment.” 439</td>
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<tr>
<td>NRSRO</td>
<td>Nationally Recognized Statistical Rating Organizations: used under Basel II to determine the risk inherent in investments held by a...</td>
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<td>financial institution when calculating their net capital reserve requirements.</td>
<td><strong>OCC</strong></td>
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<tr>
<td>Requires improvements in internal auditing, credit control, settlement systems management, business process and human resources management.</td>
<td><strong>Operational risk</strong></td>
</tr>
<tr>
<td><strong>OTD</strong></td>
<td>Originate-to-distribute: The financial business model by which financial contracts are packaged and sold to the market for asset-backed securities in order to generate fee income while eliminating risk exposures to the originators. Reforms to this practice are known as “keeping some skin in the game.”</td>
</tr>
<tr>
<td><strong>OTC</strong></td>
<td>Over the counter transactions: Trades outside centralized exchange marketplaces occurring between banks and other counterparties (“bilaterally traded”). The alternative considered in connection with Basel III is to curtail OTC trading by encouraging the use of “central counterparties”.</td>
</tr>
<tr>
<td><strong>PCA</strong></td>
<td>Prompt Corrective Action: since December 1992 regulators must take Prompt Corrective Action if a bank falls outside of the “well capitalized” zone. 446</td>
</tr>
<tr>
<td>----------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Pfandbriefe</strong></td>
<td>A type of bond issued by German mortgage banks that is similar to mortgage-backed securities in the United States. These types of bonds represent the largest segment of the German private debt market and are considered the safest debt instruments in the private market. 447</td>
</tr>
<tr>
<td><strong>Pillar 1</strong></td>
<td>Refers to the first of the three “pillars” introduced in the Basel II Accord. “Pillar 1” is concerned with the issue of capital adequacy.</td>
</tr>
<tr>
<td><strong>Pillar 2</strong></td>
<td>The Supervisory Review Process pillar of Basel II.</td>
</tr>
<tr>
<td><strong>Pillar 3</strong></td>
<td>The “market discipline” pillar of Basel II.</td>
</tr>
<tr>
<td><strong>Procyclical</strong></td>
<td>Refers to the phenomenon that, over time, the dynamics of the financial system and of the real economy reinforce each other, increasing the amplitude of booms and busts and undermining stability in both the financial sector and the real economy. 448 Requiring banks to raise capital during a recession (due to increased risk resulting from worsening business credit conditions) reinforces the contraction of the economic system. 449</td>
</tr>
<tr>
<td><strong>QIS</strong></td>
<td>Quantitative Impact Studies. Employed by the BCBS to assess the impact of proposals for changes in regulatory capital. An integral step in the “iterative process” of Basel since they provide regulators and</td>
</tr>
</tbody>
</table>
banks with an opportunity to compare notes on the potential impact of new capital adequacy regulations.450

<table>
<thead>
<tr>
<th>Regulatory arbitrage</th>
<th>Taking advantage of a fractured financial regulatory structure to “shop for” the most lenient regulator.451</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory Capital</td>
<td>The minimum level of capital that banks must maintain by regulation.452</td>
</tr>
<tr>
<td>Regulatory capital arbitrage</td>
<td>Tarullo cites two variants: “an incentive for banks to adjust their activities to exploit opportunities to lower their minimum capital levels while maintaining their return on assets or to increase their returns while keeping their capital levels constant.”453</td>
</tr>
<tr>
<td>Regulatory Capture</td>
<td>Occurs when a state regulatory agency created to act in the public interest advances the commercial or special interests that dominate the industry or sector it is charged with regulating.</td>
</tr>
<tr>
<td>Regulatory colleges</td>
<td>Transnational cooperation bringing together financial regulators to discuss issues associated with large banks on a worldwide basis.454</td>
</tr>
<tr>
<td>Repos and reverses</td>
<td>Formally “repurchase agreements” and “reverse repurchase agreements”: the purchase or sale of securities for a specified period at an agreed rate (“the repo rate”). In a “tri-party repo”, a custodian bank acts as an intermediary between the two parties to the repo.</td>
</tr>
<tr>
<td>Repo 105</td>
<td>A technique exploited by Lehman Brothers in order to briefly reduce</td>
</tr>
</tbody>
</table>
its capital requirements (increasing its leverage) as reflected on the company's published balance sheet.  

<table>
<thead>
<tr>
<th>Risk-weighted assets</th>
<th>Used to determine a financial institution’s capital requirement by adjusting the value of an asset for risk.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shadow banking system</td>
<td>Non-depository banks and other financial entities such as investment banks, hedge funds, and money market funds that play a critical role in the global financial system but are not subject to the same safety and soundness regulations (i.e. the Basel Accords) as depository banks.</td>
</tr>
<tr>
<td>Securitization</td>
<td>The financial practice of pooling a wide variety of debt instruments done with individuals and corporations into securities that can be sold to a financial marketplace. The practical effect is to transfer the financial risk (and reduce the capital requirement) from the original creators of the debt instrument to other investors.</td>
</tr>
<tr>
<td>SMEs</td>
<td>Small and Medium-sized Enterprises: in the European Union, refers to companies whose size or turnover falls below certain limits. The impact of proposed capital requirements on SMEs became a significant source of conflict in the negotiations of Basel II.</td>
</tr>
<tr>
<td>SSG</td>
<td>The Senior Supervisors Group. Twelve supervisory agencies from Canada, France, Germany, Great Britain, Italy, Japan, Netherlands, Spain, Switzerland, and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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<tr>
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</tr>
<tr>
<td>SFRC</td>
<td>Shadow Financial Regulatory Committee. A group of publicly recognized, independent experts on the financial services industry who meet regularly to study and critique regulatory policies.\footnote{457}</td>
</tr>
<tr>
<td>SIV / SPE / SPV</td>
<td>Structured Investment Vehicle / Special Purpose Entities / Special Purpose Vehicles: Off-balance entities used to “park” investments (rather than on a financial institution’s balance sheet).\footnote{458}</td>
</tr>
<tr>
<td>Solvency</td>
<td>The degree to which current assets exceed current liabilities. Unlike a “liquidity crisis” (in which a bank can be kept afloat by an injection of temporary funds) an insolvent bank can be seized and shut down by financial regulators.</td>
</tr>
<tr>
<td>Structured finance</td>
<td>The broad field of the securitization of financial assets (such as mortgages, credit card receivables, auto loans) and the use of complex legal and corporate entities to help transfer risk and open up new sources of financing to consumers.\footnote{459}</td>
</tr>
<tr>
<td>“Super senior”</td>
<td>The highest rated “tranche” of a collateralized debt obligation (CDO) with supposedly very low exposure to risk. If defaults on individual mortgages comprising the CDO exceed a certain threshold level, holders of “super senior” debt are more likely to receive at least a portion of their original investment.\footnote{460}</td>
</tr>
<tr>
<td>“Supervisory”</td>
<td>The ability of a national banking supervisor to seek an exemption from</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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<tr>
<td>discretion”</td>
<td>internationally agreed practices if they deem it necessary given the potential impact.(^{461})</td>
</tr>
<tr>
<td>Tier 1 capital</td>
<td>The core measure of a bank's financial strength from a regulator's point of view composed of the book value of common equity plus an amount of preferred stock and minority equity interests held by the bank in subsidiaries minus goodwill.(^{462})</td>
</tr>
<tr>
<td>Tier 2 capital</td>
<td>The secondary form of regulatory capital composed of supplementary capital (loan loss reserves, undisclosed reserves, revaluation reserves, general provisions, hybrid instruments and subordinated term debt).(^{463})</td>
</tr>
<tr>
<td>Tier 3 capital</td>
<td>Tertiary capital may include a greater number of subordinated issues, undisclosed reserves and general loss reserves compared to tier 2 capital. Tier 3 capital has been eliminated in Basel III as being too unreliable during periods of market crisis.(^{464})</td>
</tr>
<tr>
<td>TBTF</td>
<td>Too Big To Fail (also Too Big and Interconnected to Fail). A proposal was discussed in the aftermath of the GFC to impose capital surcharges on systemically important banks. Contingent capital could play a role in meeting any systemic surcharge requirements.(^{465})</td>
</tr>
<tr>
<td>VaR</td>
<td>VaR is the risk management technique developed at the request of J. P. Morgan CEO Dennis Weatherstone for a “4:15 report” that combined all of the firm’s risk on one page, available within 15 minutes of the market close.(^{466}) With its increasing usage, the BCBS</td>
</tr>
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<td>decided to incorporate the measurement of market risk into Basel II.467</td>
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<tr>
<td>Basel III includes the proposal for the introduction of the stressed market ( \text{VaR} ) requirement for banks that use the Internal Models Approach.468</td>
<td></td>
</tr>
</tbody>
</table>
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36 Motyl 2003.
37 The source of this chart is Dolan 2010.
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50 Brunnermeier 2009.
52 See also Deane and Pringle 1995 and Goodhart 1988 on central banks.
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64 Keohane 1989, 103.
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72 Keohane and Nye 2000,115.
73 Simmons 1998,89.
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