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# From failure to failure: The politics of international banking regulation

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## ABSTRACT

It is now clear that Basel III, a much discussed set of proposals to govern the international banking system drawn up by the Basel Committee on Banking Supervision, has fallen far short of its creators' aims. Even more puzzlingly, this is not without precedent. Eleven years ago, partly in response to the Asian financial crisis of 1997, the Basel Committee attempted to overhaul global banking rules in order to enhance the stability of the global financial system. The culmination of its five-year efforts, the Basel II Accord, was abandoned by regulators before ever being fully implemented. In this paper, I ask why Basel II failed to meet the Basel Committee's original objectives and why Basel III has met a similar fate. Drawing on recent work on the politics of global regulation, I present a theoretical framework which emphasizes the importance of timing and sequencing in determining the outcome of rule-making in global finance. The success of this framework in explaining the failure of Basel II and Basel III is an invitation to scholars in the field of International Relations to take 'time' seriously as an analytical variable.

## KEYWORDS

Financial regulation; institutional theory; regulatory capture; historical institutionalism; Basel III; international political economy.

## 1. INTRODUCTION

The much discussed Basel III proposals, a set of rules to govern the international banking system drawn up by the Basel Committee on Banking Supervision (BCBS), have been the centrepiece of efforts to strengthen the global financial architecture in the wake of the recent economic crisis. However, despite the enormous political will behind them, the proposals have fallen far short of their creators' aims. Even more puzzlingly, this is not without precedent. Eleven years ago, partly in response to the

Asian financial crisis of 1997, the Basel Committee attempted to overhaul global banking rules in order to ‘promote safety and soundness in the financial system’ (BCBS, 1999: 5). The culmination of its five-year efforts, the Basel II Accord, was abandoned by regulators before ever being fully implemented. In this paper, I ask why Basel II failed to meet the Basel Committee’s objectives and why Basel III has encountered a similar fate. In other words, I ask why international banking regulation has gone from failure to failure.

To answer this question, I build on foundational theoretical work on the politics of global regulation by Walter Mattli and Ngaire Woods (2009). Mattli and Woods set out the conditions under which different regulatory outcomes – such as those that serve narrow vested interests (capture regulation) and those that serve the broader public interest (common interest regulation) – are expected to occur. I argue that Mattli and Woods’ framework, as a comparative-static analysis, neglects key *temporal* dimensions of regulation that are central to any understanding of process-related politics. It is only by conceiving of rulemaking as a process that unfolds over time that we can understand the full range of factors that give rise to different regulatory outcomes. I outline an alternative analytical framework, drawing on historical institutionalism – both classical variants and more recent refinements of the theory in the context of cross-border market regulation – which offers powerful insights into the politics of the Basel process (Farrell and Newman, 2010; Fioretos, 2010; Posner, 2010). Specifically, it allows us to understand why certain actors, namely large international banks, were able to systemically manipulate the provisions of Basel II and Basel III to their advantage, extracting rents and maximizing profits at the expense of other stakeholders. In both cases, the ultimate consequence was an agreement that failed to achieve the Basel Committee’s initial objectives. The success of this ‘dynamic’ framework in accounting for the failure of Basel II and Basel III is an invitation to scholars in the field of International Relations (IR) to take ‘time’ seriously as an analytical variable.

There are few areas of regulation as closely linked to broader macroeconomic stability and efficiency as banking regulation. Banks occupy a pivotal position in the economy, both as the basis of an efficient payments system and the key agents of financial intermediation – that is, transforming the savings of those with a surplus (lenders) into productive investment by those with a deficit (borrowers). In part to protect the deposit insurance fund and in part to minimize the enormous negative externalities associated with bank failures, regulators impose a variety of prudential standards on banks aimed at ensuring their soundness throughout the economic cycle. Over the past 25 years, capital adequacy requirements have emerged as the dominant form of prudential regulation. The rationale for regulatory capital – largely made up of shareholders’ equity – is

to provide a buffer against unexpected losses, allowing banks to avoid default during periods of low or negative earnings.

Unfortunately for the banks, capital requirements come at a cost. Equity is a significantly more expensive source of financing than debt, largely due to tax advantages and implicit government guarantees for the latter.<sup>1</sup> When banks are forced to maintain capital buffers exceeding their preferred level, they view these requirements as a form of 'regulatory taxation'. By lowering capital levels, banks can reduce funding costs, increase leverage and boost their return on equity. For institutions with sizeable asset bases, a tiny percentage of reduction in capital requirements can represent a wind-fall of billions of dollars. By hijacking the negotiations for Basel II and Basel III, large international banks succeeded in minimizing their required levels of capital, with potentially disastrous consequences for the stability of the international financial system. Understanding why these initiatives failed to achieve the proper goals of capital regulation has important implications for future efforts to reform global regulatory standards and, as a consequence, for the future health of the global economy. Such an investigation will yield substantive conclusions about the conditions needed to produce rules that serve the interests of society as a whole – and not just the interests of those being regulated.

This paper is organized as follows. Section II begins with a brief history of the Basel Committee, culminating in its failure to achieve its stated aims for Basel II. This is followed by a critical assessment of the existing explanations for this failure in the IR literature. Section III presents my dynamic theoretical framework and then examines the events leading up to the publication of Basel II, testing the hypotheses derived from my framework through the method of process tracing. Section V turns to the latest attempt to revise international capital adequacy standards, Basel III. I argue that the very same factors that caused Basel II's failure have prevented any meaningful progress for its successor.

## 2. BASEL II

### Origins and failure

The BCBS was established in 1974 at the Bank for International Settlements (BIS), a meeting place for central bankers created after World War I. Until very recently, the Committee consisted of members of the Group of Ten (G-10) plus Luxembourg and Spain, each represented by their central bank and the authority responsible for domestic banking supervision (where this was not the central bank).<sup>2</sup> Although the Committee's initial work focused on determining the responsibilities of home and host country regulators vis-à-vis cross-border banks, its mandate expanded in the 1980s as regulators in the United States (US) looked for a way of defending

their domestic banking industry against increasing Japanese competition. The 1988 Accord on Capital Adequacy (Basel I), the first international framework for the capital regulation of major banks, set minimum capital requirements based on two ratios – a ratio of Core Tier 1 capital to risk-weighted assets of 2 per cent and a ratio of Tier 1 plus Tier 2 capital to risk-weighted assets of 8 per cent (BCBS, 1988).<sup>3</sup> Assets were risk weighted according to the credit risk of the borrower – i.e. the risk that the borrower will default on his loan. Government bonds, for example, had a zero per cent risk weighting, which meant that no capital was required to back them. Corporate loans, on the other hand, had a 100 per cent risk weighting, which meant that capital constituting the full 8 per cent of the value of the loan was needed to back them.

By the late 1990s, Basel I had come to be seen as a blunt instrument that was ‘useless for regulators and costly for banks’ (quoted in Wood, 2005: 129). The Asian financial crisis demonstrated that the risks facing banks had become more complex and that the existing capital framework had failed to keep up with the pace of financial innovation. Basel I provided easy opportunities to engage in regulatory arbitrage – exploiting the difference between economic risk and regulatory requirements to reduce capital without reducing risk. First, under its crudely defined risk categories, the same amount of capital was required to back assets with very different risk profiles (such as loans to secure blue-chip companies and retail customers’ overdrafts). This gave banks an incentive to move towards riskier, higher-yielding assets within a given risk category (from blue-chip loans to retail overdrafts). Second, Basel I’s narrow focus on the traditional ‘originate-to-hold’ model of banking provided incentives for banks to shift assets off the balance-sheet to lower capital requirements, typically through securitization.<sup>4</sup> The consequence of these activities was that overall capital levels in the banking system, which had risen sharply after Basel I came into effect in the early 1990s, were now beginning to decline.<sup>5</sup>

In September 1998, the BCBS announced that it would officially review Basel I with the aim of replacing it with more stringent rules. According to the BCBS, the new accord would have the following key objectives: ‘(1) The Accord should continue to promote safety and soundness in the financial system and, as such, the new framework should at least maintain the current overall level of capital in the system; (2) The Accord should continue to enhance competitive equality; (3) The Accord should constitute a more comprehensive approach to addressing risks’ (BCBS, 1999: 5). After five years of negotiations, notice-and-comment rounds and impact studies, the BCBS finally announced that it had agreed on a new capital framework, the Basel II Accord. This new accord rested on three ‘pillars’. In addition to specifying minimum capital requirements (Pillar 1), it provided guidelines on supervision for national regulators (Pillar 2) and created new

information disclosure standards for banks in order to enhance market discipline (Pillar 3).

As the regulatory process drew to a close, however, it became painfully clear that the accord had failed to achieve *any* of its stated objectives. With respect to the first and second objectives, the Committee's decision to establish an 'advanced internal ratings-based (A-IRB) approach' in Pillar 1 was crucial. Under the A-IRB approach, banks were for the first time permitted to use their own models to estimate various aspects of credit risk, an innovation intended to more closely align regulatory capital with underlying risk.<sup>6</sup> Smaller banks, which lacked the resources to operate internal models, would adopt the 'standardized approach', a more refined version of Basel I linking categories to external ratings provided by credit rating agencies. As well as failing to improve the accuracy of credit risk assessment, the use of internal ratings would result in large capital reductions relative to Basel I. The fourth official 'Quantitative Impact Study' (QIS), for instance, showed that A-IRB banks would experience an average drop in minimum capital requirements of 15.5 per cent and a median reduction in Tier 1 capital of 31 per cent (US regulatory agencies, 2006: 5). Since the large banks adopting this approach account for a significant share of the market, overall capital levels in the banking system would almost certainly decline – on QIS-4 estimates by up to 20 per cent in the US – in explicit contradiction of Basel II's primary objective (US regulatory agencies, 2006: 15).

The introduction of internal ratings would also give the largest banks a substantial competitive advantage over smaller rivals, breaching the Committee's second objective of enhancing competitive equality among banks. The 2006 QIS-5, for example, showed that A-IRB banks would experience a capital reduction of up to 26.7 per cent, while banks adopting the standardized approach would experience a 1.7 per cent *increase* in capital requirements (BCBS, 2006: 2). Larger institutions would be able to free up capital, expand their asset bases and maximize profits under Basel II; smaller banks, meanwhile, would be forced to deleverage and liquidate assets, reducing their profitability and potentially curbing lending to small and medium enterprises (SMEs). Indeed, a 2006 survey of more than 300 banks by Ernst and Young found that 75 per cent believed that Basel II would benefit the largest banks employing advanced risk modelling systems at the expense of institutions unable to adopt them (Thal, 2006). Basel II, despite the Committee's original intentions, would create clear winners and losers.

Finally, Basel II did not constitute a more 'comprehensive' approach to addressing risks. The accord decisively failed to capture the previously unregulated risks earmarked by the Basel Committee at the beginning of the regulatory process. Provisions for trading book instruments such as credit derivatives were conspicuously absent, in spite of the Committee's

awareness that banks' trading portfolios had mushroomed as a result of Basel I.<sup>7</sup> The treatment of market risk, the only type of trading book risk the BCBS attempted to regulate, was little better: Banks would be allowed to use complex mathematical models to produce estimates of 'value-at-risk' (VaR), even though these models had been shown in the late 1990s to vastly underestimate the probability of 'extreme' market events.<sup>8</sup> Finally, negligible levels of capital were required for rated securitized assets – precisely those assets that incurred the largest losses in the recent crisis. As a result, according to QIS-5, A-IRB banks would see overall securitization capital requirements fall by between zero per cent and 17.3 per cent, while other banks would experience an increase of between 7.7 per cent and 10.2 per cent – figures that also undermined the BCBS' objective of maintaining competitive equality (BCBS, 2006: 32).

### A review of the IR literature on Basel II

What explains the astonishing gap between the Basel Committee's initial aims for Basel II and the end product of the regulatory process? Although the politics of the Basel process have received relatively little attention in the academic literature, it is possible to distinguish three schools of thought regarding the outcome of Basel II. The first, which draws on realist theory in the field of IR, explains the shape of the accord in terms of the distribution of power in the international economy. The US, as the most powerful member of the BCBS, is said to have systematically promoted the interests of its domestic banks at the expense of the financial institutions from other countries. Thus Duncan Wood (2005), the most prominent advocate of the realist account, argues: 'The ability of the United States to obtain international agreements that reflect its interests and those of its banks has been the single most important factor in determining outcomes in the [Basel] Committee' (Wood, 2005: 163). There is, however, little evidence of the US playing the role of hegemonic leader in the case of Basel II. American regulators have been heavily criticized in recent years by Congress for putting the country's regional banks at a competitive disadvantage – hardly the behaviour of a hegemon bent on furthering its national interests.<sup>9</sup> Contrary to Woods' claims, Basel II promotes the interests not of particular countries on the Basel Committee, but of large international banks *regardless* of their national origin.

A second analysis of the Basel process, favoured by scholars such as Edward Kane (2007), Ethan Kapstein (2006) and Daniel Tarullo (2008), builds on Robert Putnam's (1988) well-known model of international diplomacy as a 'two-level' game. In its most basic formulation, the model predicts that governments will seek to reach an agreement at the international level that is likely to be accepted by a broad coalition of interest groups at the domestic level in a separate 'ratification phase' (Putnam, 1988: 434).

International agreements will occur when the 'win-sets' of negotiators – the sets of all possible agreements that would be ratified by a majority of domestic constituents – overlap with one another. While usefully highlighting the role played by domestic groups in international negotiations, such models fail to provide a compelling account of Basel II. Contrary to their predictions, Basel II did not satisfy a broad coalition of domestic interests across member countries; it favoured one set of actors, namely large international banks, at the expense of all others. Failure to explain this outcome reflects a *misapplication* of the two-level model, rather than a flaw in its conceptual framework. Basel II was not the product of traditional interstate negotiations, but the culmination of discussions between unelected regulators whose agreements did not require meaningful ratification by domestic stakeholders. Under these very different conditions, as I explain in section III, policy outcomes will reflect the preferences of those that are the first to arrive at the decision-making table, not the preferences of a broad coalition of domestic interests.

A third and more promising analysis views Basel II as the product of regulatory capture by large international banks in G-10 countries. Seeking to account for the accord's bias against low-rated sovereign, corporate and bank borrowers – borrowers belonging predominantly to developing countries – scholars such as Stephany Griffith-Jones, Avinash Persaud and Geoffrey Underhill have argued that Basel II was shaped by 'the excessive influence by the large financial institutions domiciled in the countries represented on the Committee' (Griffith-Jones and Persaud, 2003: 2; Claessens, Underhill and Zhang, 2006). By drawing attention to the issue of capture, these scholars have taken an important step towards explaining why regulators, despite setting out with good intentions, may in the end fail to achieve their aims. Having said that, they stop short of presenting a full framework for the analysis of capture, leaving important questions unanswered: Why do some policy processes restricted to G-10 countries not fall victim to capture? Why are some processes that incorporate a broad range of stakeholders still captured? And why is it that it is large international banks, rather than their smaller counterparts, that invariably succeed in securing their preferred rules? In order to answer these questions, it is necessary to systematically spell out the conditions under which capture will occur. In the next section, I outline a framework setting out these conditions.

### 3. EXPLAINING THE FAILURE OF BASEL II

#### Overview of the analytical framework

The point of departure for my analytical framework is Walter Mattli and Ngaire Woods' (2009) recent work on the politics of global regulation.

Contrasting regulatory change that serves the common interest with regulatory change that benefits narrow vested interests as a result of regulatory capture, Mattli and Woods set out the broad conditions under which these outcomes will occur in global rulemaking. The first set of conditions, the so-called 'supply side' conditions, concern the institutional context in which rules are drafted, implemented, monitored and enforced. An 'extensive' institutional context, characterized by open forums, proper due process, multiple access points and oversight mechanisms, is said to be less liable to be captured than a 'limited' context that is exclusive, closed and secretive. But unlike many legal scholars (particularly in the field of global administrative law), Mattli and Woods reject the idea that an extensive institutional context is sufficient to secure common interest regulation. Unless certain 'demand side' conditions are also satisfied, the outcome will be one of capture. First, constituencies adversely affected by the regulatory status quo must have proper information about the social cost of capture. Second, these constituencies must be supported by public or private 'entrepreneurs' providing technical expertise, financial resources and an organizational platform for them. Finally, crucial to the success of public-private alliances is a shared set of ideas about how to regulate, around which diverse actors can unite in a pro-change coalition.

By moving beyond the naïve assumptions of legal theory, Mattli and Woods have undoubtedly advanced the study of global regulation. As a comparative-static analysis, however, their framework suffers from a crucial limitation: It neglects key *temporal* dimensions of regulation that are central to any understanding of process-related politics. Creating rules is a cumulative process that unfolds over time and it is only by drawing out the causal implications of timing and sequencing that we can understand the full range of factors contributing to different regulatory outcomes. In the rest of this subsection, I present a 'dynamic' framework which, by placing regulation in its proper temporal context, offers us a richer and more comprehensive understanding of international regulatory processes.

My framework proceeds from two premises. First, rulemaking is a multistage bargaining process, the outcome of which reflects the preferences of (at least some) actors that participate in it. Second, in any given regulatory process, certain groups arrive at the decision-making table well before the others. Why is this analytically significant? The answer is that actors claiming 'first-mover advantage' have enormous leverage at a critical juncture in the regulatory process, since policy decisions made at an early stage tend to be self-reinforcing. As more resources are invested in a given policy, historical institutionalism reminds us, the costs of abandoning that policy in favour of once-possible options increase commensurately. It becomes more and more difficult, meanwhile, for latecomers to reverse the trend. As Paul Pierson puts it: 'If early competitive advantages may be self-reinforcing, then *relative timing* may have enormous

implications . . . groups able to consolidate early advantages may achieve enduring superiority. Actors arriving later may find that resources in the environment are already committed to other patterns of mobilization' (Pierson, 2004: 71). Exit costs are particularly high in the context of global regulation given the significant investment typically required by market actors in order to comply with new rules. We should therefore expect actors claiming first-mover advantage in international regulatory processes to exert a disproportionate influence over the content of rules relative to actors arriving later.

The implications for students of global regulation are significant. Once we recognize the independent causal effects of differential timing in the regulatory process, it becomes clear that no set of comparative-static factors are sufficient for explaining policy outcomes. This does not render Mattli and Woods' framework irrelevant. The institutional context in which rules is created remains a key explanatory variable; a lack of due process can lead to capture even if no group is able to claim first-mover advantage. Similarly, on the demand side, where temporal variables most naturally fit, the three factors identified by Mattli and Woods may still play a role in determining the shape of new rules. The key point is that when it comes to events and processes that are firmly rooted in a particular temporal context – such as international rulemaking – these factors will not be enough to explain policy outcomes. It is only by considering *when* different actors emerge, and *how* this empowers or undermines them with regard to their respective objectives, that we can capture the true dynamics of process-related politics.

As well as incorporating insights from classical historical institutionalism, my analytical framework complements recent refinements of the theory in the context of cross-border market regulation by scholars such as Henry Farrell, Abraham Newman, Orfeo Fioretos and Elliot Posner (Farrell and Newman, 2010; Fioretos, 2010; Posner, 2010). By highlighting the role of mechanisms such as feedback loops and sequencing effects in determining states' bargaining strength in international negotiations, these analyses have considerably enhanced our understanding of the temporal dimensions of global regulatory processes. However, their traditionalist focus on the horizontal distributional battles fought *between* states means that they fail to address the equally important vertical battles that are fought *within* states. In other words, these studies overlook the political economy of rent-seeking. The distributional conflicts played out between competing groups in the domestic arena – in particular, large internationally active banks and small-scale community lenders – are at the heart of my analytical framework.

While complementing these analyses, my framework also seeks to extend them in two ways. First, it confronts a question typically neglected by historical institutionalists: Why do some actors arrive before others in

the first place? That is, it endogenizes first-mover advantage. I hypothesize that it is actors with the best *information* about the regulatory agenda, typically through personal contacts within the regulatory community, that are most likely to claim first-mover advantage. Having good information, needless to say, is not the same as having abundant material resources. In the case of Basel II, for instance, the five American banks with the greatest influence on the accord – through their membership of powerful banking lobbies – had a combined deposit market share of only 36 per cent in the US.<sup>10</sup> It was not their resources *per se* that were key to their success in shaping the accord, but their superior access to information about the Basel Committee's agenda – a very different kind of advantage based on their personal relationships with members of the Committee.

Second, my framework sets out the conditions under which timing is expected to be a salient variable, an issue that has received little attention from historical institutionalists. Early participation will confer a decisive advantage on actors only under limited circumstances, namely when negotiators have little effective accountability to domestic constituents. This condition is invariably satisfied in the case of complex technical rules such as capital requirements. Timing has little consequence, on the other hand, when international agreements must be endorsed by well-informed domestic legislators in a separate 'ratification phase'. The existence of a meaningful ratification phase nullifies the potential gains from early participation since any deal can be later rescinded by opposed domestic constituents. In these cases, we should expect regulatory outcomes to be determined by the original comparative-static factors identified by Mattli and Woods. Though a theoretically significant qualification, we will see below that it is not one that applies to the Basel Committee, a body whose dictates are subject to minimal domestic legislative scrutiny.

To summarize, Mattli and Woods' framework can be strengthened as a theory of global regulatory processes by proper temporal contextualization. When international agreements are subject to effective domestic ratification, each party's timing has little import and the outcomes will only reflect the comparative-static factors identified by Mattli and Woods. But when agreements lack such a ratification phase, as in the case of Basel II, timing takes on enormous significance. Actors with the best information about the regulatory agenda will arrive first at the decision-making table, giving them disproportionate influence over the substance of new rules. Those arriving later, meanwhile, will struggle to have any bearing on negotiations, facing an increasingly entrenched set of proposals.

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

In this subsection, I draw out a set of hypotheses about the outcome of Basel II based on the dynamic framework outlined above and I test them

using the method of process-tracing. A close examination of Basel Committee documents, press releases, interview transcripts and other sources provides strong evidence that large international banks – the hypothesized first movers in the Basel process – played a key role in the Committee’s failure to achieve its objectives for the accord.<sup>11</sup> The results of the examination are summarized in Table 1.

In order to understand the theoretical implications of my analysis for Basel II, we must begin by identifying the first movers in the regulatory process. These are expected to be large international banks and, in particular, the Institute of International Finance (IIF), a powerful Washington-based lobby representing major US and European banks, whose superior information about the regulatory agenda derived from its personal links with the Basel Committee. The longest-serving Chairman of the Committee, the Bank of England’s Peter Cooke (1977–88), was in fact one of the co-founders of the IIF.<sup>12</sup> The Chairman of the BCBS in the mid-1990s, the Bank of Italy’s Tommaso Padoa-Schioppa, was a close associate of Charles Dallara, Managing Director of the IIF since 1993. Indeed, it was after meeting at a social occasion in March 1995 that the two agreed to establish an ‘informal discussion’ on regulatory issues between financial institutions and supervisors under agreed ‘ground rules’ of strict confidentiality.<sup>13</sup> These links became even stronger under the chairmanship of William McDonough (1998–2003), a head of the New York Federal Reserve who presided over almost all of the Basel Committee’s work on Basel II. Another close friend of Dallara’s from his 22 years at the First National Bank of Chicago, McDonough gave the IIF unprecedented access to the Committee from the earliest stages of the reform process. Before negotiations had even been initiated, the institute had established a new body, the Steering Committee on Regulatory Capital, specifically to advise the Basel Committee regarding the drafting of Basel II.

My framework therefore leads us to predict that large international banks, as first movers in the Basel process, would shape the provisions of Basel II in a way that was increasingly difficult to reverse at later stages. The disadvantages faced by second-movers would be reinforced by severe limitations on the supply side: The Basel Committee of 1999 to 2004 had one of the worst records of all international standard-setters in terms of transparency, representation and accountability.<sup>14</sup> The Committee’s meetings (which occurred four times per year) were closed to the public, with no record of who was present, what was discussed or which outside interests were consulted.<sup>15</sup> Further, the Committee only included representatives from the G-10 countries, despite consciously creating global standards. While members often point to the work of the International Liaison Group, which represented the interests of large developing countries during the negotiations, there is only so much influence that these countries could exert without formal representation on the Committee. Finally, few

**Table 1** Initial proposals and regulatory outcomes in Basel II

	Initial proposal	Industry lobby	Industry recommendation	Final proposal (Basel II)
<b>Internal ratings</b>	Incorporate external credit ratings into new framework	IIF	Recognize internal credit risk models of large banks	Recognition of internal ratings for large banks in A-IRB approach
<b>Trading book</b>	Introduce capital charge for derivatives risk ('w factor')	ISDA	Abolish 'w factor'	'W factor' abolished in September 2001
	Introduce standardized methodology to capture market risk	IIF	Substitute standardized methodology for VaR models	Recognition of VaR models in 1996
<b>Securitization</b>	Link risk categories to external credit ratings	ESE, IIF	Lower risk weights for rated tranches	Reduced weights for rated tranches

mechanisms existed for holding the Committee to account. Since its members are drawn from independent regulatory agencies rather than governments, they are not subject to domestic legislative control. While its agreements usually require formal endorsement from legislators, the highly technical nature of capital requirements ensures that effective accountability cannot be exercised in practice. The lack of a *real* ratification phase for the Basel Committee's dictates, as suggested earlier, guaranteed that the logic of first-mover advantage held true for Basel II.

In short, the conditions prevailing in the negotiations for Basel II strongly favoured an outcome of regulatory capture by large international banks. As the best informed about the Basel Committee's agenda, these banks are expected to gain first-mover advantage in the regulatory process, exercising undue influence over the specifications of Basel II. Latecomers, in particular regional and developing country banks, are predicted to have negligible impact on the accord, impeded both by lack of information about the regulatory agenda and a limited institutional context. In the next two subsections, I test these hypotheses against the events of the Basel process.

### Internal ratings

As discussed in section II, the Basel Committee's failure to achieve its first and second aims was a consequence of its decision to create an A-IRB approach to credit risk. Central to this decision was the IIF, which had lobbied aggressively for greater recognition of banks' own risk measurement systems from as early as November 1997 on the grounds that they were more risk-sensitive than Basel I's arbitrary risk weights (IIF, 1997). The proposal was initially met with scepticism by regulators. At the September 1998 conference at which the Basel Committee announced its agenda for revising Basel I, Bank of England economists presented a study showing that there were 'significant hurdles' to the use of internal ratings due to their lack of transparency (Jackson, Nickel and Perraudin, 1999: 100). A similar study by two Federal Reserve economists found the state of ratings systems in large American banks to be far less advanced than previously assumed (Treacy and Carey, 1998). While the first consultative paper for Basel II discussed the possibility of an A-IRB approach to credit risk for 'some sophisticated banks', only a few paragraphs were devoted to the idea (BCBS, 1999: 37).

This quickly changed as the IIF's lobbying efforts intensified. In addition to putting private pressure on the Basel Committee, in February 2000, the IIF published a report emphasizing the robustness of internal credit risk models (in addition to their effectiveness in 'maximizing shareholder value') (IIF/ISDA, 2000). IIF Chairman Sir John Bond, meanwhile,

publicly called on the BCBS to recognize internal ratings in order to '[enhance] the competitiveness of banks by bringing individual banks' capital requirements more in line with actual risks' (Ibison, 2000). Revealingly, a Committee representative from Britain's Financial Services Authority (FSA) admitted that 'more regulators around Europe are coming round to the view that a large number of banks should be able to qualify for internal ratings', and that the Committee may consequently drop its prior commitment to maintaining the current level of capital in the banking system (Ibison, 2000; Cameron, 2000). By mid-2000, every member of the Committee had come around to the IIF's view and the working group on credit risk began informal work with the IIF to formally incorporate internal ratings into Basel II.<sup>16</sup> The second draft's detailed exposition of the A-IRB approach was enthusiastically welcomed by the IIF's Steering Committee as one of seven areas in which its recommendations had already been adopted (IIF, 2001a: 6).

By the time the other banks became aware of these developments – the release of the second draft paper in 2001 – internal ratings were already an integral part of Basel II. As the Vice-President of a leading association of American community banks put it, 'We didn't get involved until what turned out to be a late stage . . . And when we did, the modelling (A-IRB) approach was already set in stone. The Basel Committee had been convinced by the large banks.'<sup>17</sup> The few comments on the draft paper submitted by small banks reflected serious apprehensions about Basel II's competitive implications. Among the loudest voices were the Second Association of Regional Banks, a group representing the Japanese regional banking industry, and Midwest Bank, an American regional bank, which complained that the few large banks qualifying for the A-IRB approach 'will not be required to keep the same level of capital against financial instruments as 99 per cent of the financial institutions in this nation who cannot qualify under these standards' (Midwest Bank, 2001: 1). These concerns were best expressed by America's Community Bankers (ACB), a group representing community banks across the US, which protested that 'the Accord will benefit only the most complex and internationally active banks, saddling the vast majority of financial institutions in the United States with a cumbersome and expensive capital regulatory scheme . . . [T]he proposed bifurcation between the standardized and internal ratings-based approaches to establishing minimum capital requirements will competitively disadvantage many smaller banking institutions that lack the resources necessary for developing a finely calibrated IRB assessment system' (ACB, 2001: 2).

Competitive fears were not confined to small banks. Several developing countries also expressed fears that they would be disadvantaged under the new rules. Commenting on the second draft paper of Basel II, the Reserve Bank of India complained that by failing to qualify for internal ratings, developing country banks would experience a 'significant increase' in

capital charges (RBI, 2001: 2). The People's Bank of China stated that the proposals 'basically address the needs of large and complex banks in G-10 countries' (PBC, 2001: 2). The Banking Council of South Africa pointed out that while 'the Accord aims at "competitive equality", the bigger, more advanced banks may have access to options that will give them a market advantage, whereas the smaller banks may find it difficult to afford the necessary infrastructure investments' (BCSA, 2001: 4). But these objections, like those of community banks, came too late to influence proceedings. The A-IRB approach had become an established feature of Basel II by 2001 and the costs of discarding it – both for regulators, who were under pressure to finalize the accord, and for banks, who had invested significant sums in new regulatory systems – were prohibitively high. It is no surprise that when a group of five major developing countries protested about the accord's competitive implications at a behind-closed-doors meeting in Cape Town in 2002, it was accused by Chairman McDonough of attempting to 'derail the whole process'.<sup>18</sup> In the end, only minor changes were made to credit risk approaches between the second draft paper in 2001 and the final accord in 2004.

### **Trading book, market risk and securitization**

The Basel Committee's failure to achieve its third aim – a consequence of its inadequate regulation of trading book and securitization risks – tells a similar story. Basel II's light treatment of the trading book owed much to the lobbying efforts of the International Swaps and Derivatives Association (ISDA), the largest global financial trade association, representing more than 860 institutions in the over-the-counter (OTC) derivatives industry. As one of the first organizations to comment on the new trading book framework, the ISDA managed to persuade the Basel Committee to defer to its judgement on several key provisions. One of the most important of the Committee's reversals was its September 2001 decision to drop an earlier proposal for an explicit capital charge covering the risks associated with credit derivatives. ISDA had forcefully lobbied against the measure, dubbed the 'w factor', on the grounds that it was 'unjustified in light of market practice: losses experienced on repo or credit derivatives trades had been minimal, and the contracts used to document the transactions were enforceable and effective' (Boland, 2001). Committee's reversal, as the *Financial Times* noted at the time, was at odds with concerns earlier expressed by members that the structure of some derivatives tended to concentrate risk, rather than disperse it (Boland, 2001). As one former Committee member admitted, 'We went too far on capital relief for the trading book. We were convinced by the industry that instruments such as credit derivatives needed a lower capital charge because they were more

liquid and suffered smaller losses. The recent turmoil has confirmed that this is false. But in good times, it's hard to go against the banks.<sup>19</sup>

The only kind of trading book risk the BCBS made a concerted effort to tackle was market risk, albeit in the mid-1990s, rather than during the official negotiations for Basel II. Even in this area, the proposals were watered down significantly in the face of industry pressure. In 1993, concerned about banks' increasing vulnerability to price fluctuations as a result of the deregulation of interest rates and capital controls, the Basel Committee proposed a standardized market risk capital charge. This would calculate capital requirements on the basis of certain characteristics of debt securities and derivatives, such as maturity, credit rating and category of borrower (BCBS, 1993). The proposal was met with strong opposition from the IIF, which insisted that it failed to recognize the most 'sophisticated' modelling techniques already in use (IIF, 1993: 2). Although reluctant at first to consider the use of VaR models, the Basel Committee began to seriously consider using them after the establishment of an informal dialogue with the IIF in early 1995 (see above). Just months later, the Committee fully endorsed the IIF's recommendation, officially recognizing the use of VaR models in a document published in April (BCBS, 1995).

This was a surprising development given the 'disparate' results from the testing exercise, which showed significant dispersion in capital charges for the same trading book among VaR models – even after the apparent factors causing variation in model output were controlled for (BCBS, 1995: 6). Even more surprising was the fact that these models passed into Basel II without question. At the very time the Committee was formulating the first draft of the accord in early 1999, banks were reporting widespread losses on Russian government bonds entirely unanticipated by their VaR models. Bankers Trust, an American wholesale bank, reported that on five days during the latest quarter, its trading account losses had exceeded its one day 99 per cent VaR calculation, a figure that statistically should be exceeded on just one day in a hundred (Graham, 1999). Most damningly, a report published by the International Monetary Fund (IMF) in December 1998 had condemned VaR models for paying 'insufficient attention' to extreme market events and assuming that the processes generating market prices were stable (IMF, 1998: 16). Despite such widespread criticism, no questions were raised within the Basel Committee about the continued use of VaR models in 1999.

Finally, Basel II's failure to create a more comprehensive approach to risk management also stemmed from its inadequate treatment of securitization. In this case, the earliest arrivers were large forums for banks specializing in off-balance-sheet assets, in particular the European Securitization Forum (ESF), which repeatedly argued that securitization 'has proven itself to be a source of safe, fixed income assets from the perspective of banks as investors' (ESF, 2001: 4). Though the credibility of such claims

has been undermined by the recent crisis, they succeeded in persuading the Basel Committee to heavily dilute its initial securitization proposals. In its first draft in 1999, the Committee proposed to directly tie capital charges for securitization tranches to external credit ratings. For all banks, tranches rated AAA or AA- would carry a 20 per cent risk weight; A+ to A-, a 50 per cent weight; BBB+ to BBB-, 100 per cent; BB+ to BB-, 150 per cent; and B+ or below, a deduction from capital. The ESF soon complained that the prescribed risk weights for rated tranches for A-IRB banks were 'excessive' – a claim supported by the IIF, which warned that the 'proposal's recommended treatment of securitization activities is too stringent and risks disrupting the valuable aspects of existing activities' (ESF, 2001: 8; IIF, 2001b: 11). The Committee halved A-IRB risk weights in response and proceeded to cut them even further over the next two years. By the publication of the final accord in 2004, they had reached dangerously low levels: Risk weights for tranches rated AAA would be just 7 per cent; AA, 8 per cent; A+, 10 per cent; A, 12 per cent; BBB+, 35 per cent; and BB, 60 per cent (BCBS, 2004b). The risk weights for rated tranches under the standardized approach, however, remained as high as in the 1999 first draft. This was a startling reversal. Indeed, the inadequate treatment of securitization under Basel I had been one of the key motivations for updating the accord in the first place.

#### 4. EXPLAINING THE FAILURE OF BASEL III

Beginning in the subprime mortgage market in the US in the summer of 2007, the recent global financial crisis has passed the most damning verdict of all on Basel II. Whether or not they saw it as a direct contributor to the crisis, supervisors agreed that the accord's basic tenets – reliance on internal risk models, capital relief for the largest banks and minimal regulation of the trading book – were all but discredited by the turmoil. A consensus arose among policymakers that a new approach to capital regulation was essential to the future stability of the international financial system. The Financial Stability Forum (FSF), an influential group of finance ministers and central bankers, issued a post-mortem report on the crisis in 2008, criticizing the 'significant weaknesses' in the existing capital framework (FSF, 2008: 12). The February 2009 De Larosière Report, a much anticipated framework for the future of European financial regulation, demanded a 'fundamental review' of Basel II on the grounds that it 'underestimated some important risks and over-estimated banks' ability to handle them' (De Larosière *et al.*, 2009: 16). These efforts culminated in a set of new and far-reaching proposals issued by the Basel Committee in December 2009, which soon became known as 'Basel III'. The proposals shook the banking industry and heralded, in the words of Basel Committee Chairman Nout Wellink, a new era of 'higher capital and liquidity requirements and less leverage in the banking system' (Westlake, 2009).

It is now clear that such claims were premature. In this section, I argue that many of the same factors that led to Basel II's failure resurfaced to undermine its successor. Despite the immense political will behind an overhaul of global capital standards following the crisis, large international banks once again managed to seize control of the regulatory process, closing the window of opportunity for substantive reform. The first part of the section describes the favourable societal and institutional conditions under which Basel III was conceived and explains how changes to these conditions in late 2009 ensured the failure of the new accord. In the second part, I test these hypotheses against events in the latest Basel process, finding compelling evidence that large banks enjoyed enormous success in securing their favoured outcomes.

### Why Basel III failed

To understand how large financial institutions were able to regain control of the Basel process, we have to return to the origins of Basel III in late 2008. The unexpected collapse of the investment bank Lehman Brothers in September 2008 saw the financial crisis spill over into the real economy. With public anger at the financial sector mounting and banking regulation becoming an increasingly politicized issue, capital adequacy standards soon became the prerogative of the G-20. This was a development with significant implications from the perspective of my dynamic framework. On the supply side, the G-20 is a forum comprised of elected political leaders whose well-publicized agendas, meetings and working groups are all open to public scrutiny. On the demand side – and especially important in my analysis – the G-20's agreements are subject to an effective ratification phase. Since any deal reached between negotiators can be scrutinized and potentially repealed by domestic constituents, early participation in the regulatory process is *not* expected to constitute a decisive advantage. Agreements reached by the group will be shaped not by early arrivers, but solely by the comparative-static supply and demand side factors identified by Mattli and Woods.

In line with Mattli and Woods' expectations, the combination of extensive institutional supply and strong public demand for regulatory change in the wake of the crisis transformed the G-20 into an effective advocate for capital adequacy reform. Two months after the Lehman collapse, the group called for international standard setters to 'set out strengthened capital requirements for banks' structured credit and securitization activities' (G-20, 2008: 2). This prompted the Basel Committee, which had failed to make a single change to Basel II since the crisis broke out, to approve a set of enhancements to the accord's trading book framework in July 2009. At the Pittsburgh Summit in September 2009, the G-20 extended its demands to the whole of the Basel II framework. Setting a deadline of

end-2010, the group ordered the Committee to formulate a new set of capital rules that would form the centrepiece of an 'international framework of reform' (G-20, 2009: 8). These rules would include higher minimum capital requirements, an international leverage ratio, liquidity ratios and a capital surcharge for systemically important institutions. The BCBS duly complied, releasing in December 2009 a set of preliminary proposals the details of which would be filled in over the next 12 months (BCBS, 2009). In a telling sign of the industry's frustration, Charles Dallara, IIF Managing Director, complained that 'political forces are driving the reform agenda, and central bankers have been marginalized in their role' (Chong, 2009).

Fortunately for banks, the December reforms package was only the beginning of the story for Basel III. With the resumption of growth in advanced economies in 2010, public demand for change soon weakened. More importantly, rulemaking returned to the Basel Committee, ensuring that the technical specifications of the new accord would be worked out not in the high-profile working groups of the G-20 but in opaque subcommittees lacking proper standards of due process and – crucially – requiring no meaningful ratification by domestic stakeholders. Under these conditions, timing is expected to *regain* its significance in the regulatory process, conferring a decisive advantage on those best informed about the policy agenda.

Once again, this advantage belonged to large financial institutions with personal links to the regulatory community. One of the most prominent members of the Basel Committee formulating the new accord, the New York Federal Reserve's Marc Saidenberg, was Head of Regulatory Policy at Merrill Lynch and a member of the IIF Committee on Market Best Practices until 2008. As recently as October 2007, the same month in which Merrill Lynch announced a record \$7.9 billion loss on subprime-related investments, Saidenberg was busy lobbying regulators to 'avoid a knee-jerk reaction to recent events' (Callan, Wighton and Guha, 2007). Senior figures in the Basel Committee, meanwhile, moved in the opposite direction. During negotiations for Basel III, Roger Ferguson, former Vice-Chairman of the Federal Reserve's Board of Governors, sat on the institute's board of directors; Darryll Hendricks, formerly of the Federal Reserve Bank of New York, chaired the IIF Working Group on Valuation; and Patricia Jackson, formerly of the Bank of England, chaired the IIF Working Group on Ratings. In perhaps its greatest coup, the IIF managed to recruit Jacques de Larosière, author of the abovementioned De Larosière Report and former Governor of the Bank of France, to head its newly formed Market Monitoring Group. Despite acknowledging in the report that the crisis 'has shown that there should be more capital, and more high quality capital, in the banking system, over and above the present regulatory minimum levels', De Larosière was quick to take up the IIF's cause (De Larosière *et al.*, 2009: 16). 'Capital ratios,' he claimed in October 2009, 'if they are not well

conceived, could substantially harm our economies. I see a great danger here. Regulators must not start piling new ratios on the existing ones, adding further requirements (leverage ratios, special ratios on large systemically important institutions, anti-cyclical capital buffers) to the normal – and revamped – Basel II risk-based system . . . Together, their impact could be lethal' (De Larosière, 2009).

My framework thus yields the prediction that large financial institutions, as the best informed about the Basel Committee's agenda, would secure first-mover advantage in the negotiations for Basel III. This would enable them to water down the proposals to irreversible effect. Second-movers, by contrast, are expected to fail to secure their desired provisions, arriving too late and facing too many institutional impediments to influence policy outcomes.

### **Minimum capital requirements, leverage ratio, liquidity ratios and capital surcharge**

How much support is there for these hypotheses? Recent developments confirm that large international banks both arrived first in the latest Basel process and enjoyed considerable success in watering down Basel III. Key provisions of the accord were relaxed, rendered non-binding (shifted from Pillar 1 to Pillar 2) and delayed from their original 2012 implementation deadline as a result of industry pressure. In the rest of this subsection, I examine four such provisions: higher minimum capital ratios, the international leverage ratio, minimum liquidity ratios and the capital surcharge on systemically important institutions. The results are summarized in Table 2.

The most contested element of the reforms package was the level of overall minimum capital standards. Months before the deadline for public comments, large banks were already releasing estimates of the detrimental impact of higher requirements on consumers and the wider economy. In February 2010, JP Morgan claimed that large banks would see their profitability fall by nearly two-thirds under higher capital ratios, pushing up the price of all financial products by 33 per cent (JP Morgan Chase, 2010: 1). In early April, BNP Paribas, the largest French bank, suggested that the reforms would result in 'either two guaranteed years of deep recession or four years of zero growth' for Europe (Daneshkhu, 2010). According to the most widely cited estimate, produced by the IIF in a report released in June 2010, a 2 per cent increase in overall capital requirements would cut cumulative economic output by 3.1 per cent in the Eurozone, the US and Japan by 2015, wiping out more than nine million jobs in the process (IIF, 2010b). These calculations were not confirmed by independent analysis. The Basel Committee's own impact study, conducted jointly with the Financial Stability Board (FSB) and released in August, found that a

**Table 2** Initial proposals and regulatory outcomes in Basel III

Initial proposal	Industry recommendation	Final proposal (Basel III)
Significantly higher minimum capital ratios	Keep new ratios low to avoid undermining economic recovery	Minimum capital ratios increased from 2% to 7% (with new definitions)
International leverage ratio	Move to Pillar 2 (i.e. non-binding)	Ratio moved to Pillar 2 until at least 2018; set at only 3%
Short-term liquidity coverage ratio (LCR)	Use less demanding stress scenario; expand definition of 'liquid assets' to include covered and corporate bonds	Relaxed stress scenarios for LCR; definition of 'liquid assets' widened
Long-term net stable funding ratio (NSFR)	Reduce discount factor for retail deposits; shift to Pillar 2	Discount factor for retail deposits lowered; NSFR placed in Pillar 2 until at least 2018
Capital surcharge for systemically important institutions	Move to Pillar 2	Surcharge placed in Pillar 2; set within a range of just 1.5% to 3%

2 per cent rise would reduce output by a mere 0.38 per cent over five years – one-eighth the size of the IIF’s estimate (BCBS and FSB, 2010: 4). Just one month after the study’s publication, however, the regulators decided unanimously against significantly higher requirements. With amended definitions of capital, the minimum Core Tier 1 capital ratio would rise from 2 per cent to 4.5 per cent, less than half of the equivalent ratio maintained by the largest banks before the crisis (BCBS, 2010b: 1).<sup>20</sup> As senior economists at the Bank of England admitted subsequently: ‘In retrospect, we believe a huge mistake was made in letting banks come to have much less equity funding . . . than was normal in earlier times’ (Miles, Yang and Marcheggiano, 2011: 37). According to their analysis, ‘a far more ambitious reform would ultimately be desirable – a capital ratio which is at least twice as large as that agreed upon in Basel would take the banking sector much closer to an optimal position’ (Miles, Yang and Marcheggiano, 2011: 36–37).<sup>21</sup> In a further concession to the banks, the new ratio would not be fully implemented until 2019, by when, as Martin Wolf of the *Financial Times* put it, ‘the world will probably have seen another financial crisis or two’ (Wolf, 2010).

It is also worth noting that while the Basel Committee sought to raise minimum standards, it did not question Basel II’s model-based approach to risk weighting. This is especially concerning given that, as Martin Hellwig has pointed out, in the run-up to the crisis, internal ratings allowed large banks to claim Core Tier 1 capital ratios of 10 per cent when they held equity amounting to just 2 per cent of non-risk-weighted assets (Hellwig, 2010: 3).<sup>22</sup> It is no coincidence that in July 2009 – months before the reforms began to take shape – the IIF released a report on the future of financial regulation demanding that any changes to capital standards be made ‘within the framework of the Basel II risk-based approach’ (IIF, 2009a: 26). This approach, the institute reiterated, ‘will continue to increase resilience by inducing ongoing improvement in risk management’ (IIF, 2009a: 9). Once again, the opposition to internal ratings came too late to count. In its April 2010 comments to the Basel Committee, the World Council of Credit Unions (WOCCU), an organization representing 54,000 non-profit credit unions, argued that ‘less reliance on the internal ratings-based approaches’ was needed to avoid future bailouts of major banks (WOCCU, 2010: 3). The Independent Community Bankers of America (ICBA), an association representing 5,000 American community banks, took an even stronger line: ‘The ICBA still maintains that the US agencies should re-evaluate [their] use of the Basel II Advanced Approach. The largest financial institutions in the United States that are now considered “too big to fail” should be subject to a more rigorous set of leverage and risk-based capital requirements than other institutions and that are not determined by the institutions themselves based on internal risk-ratings formulas’ (ICBA, 2010: 3). The

Committee received these comments almost a year after the decision to preserve Basel II's A-IRB approach was made.<sup>23</sup>

The second major part of Basel III to suffer heavy dilution was the international leverage ratio, a simple ratio of Tier 1 capital to non-risk-weighted assets intended to provide a backstop against measurement error. Lobbying efforts against the measure were led by the IIF, which, as early as mid-2009, was warning that a 'simple leverage ratio runs the risk of undermining its own objectives' (IIF, 2009a: 44). In September 2009, Charles Dallara went even further, denouncing the ratio as a 'blunt instrument' and calling for it to be only considered in Pillar 2 of the existing regulatory framework (Guha, 2009). Unfortunately, counterbalancing efforts by banks already subject to a national leverage ratio – such as those in Canada, Switzerland and the US – failed to materialize, largely because the Basel Committee's proposal (unlike existing ratios) captured off-balance-sheet assets and did not permit the netting of derivatives exposures. As one credit analyst at Moody's put it, the proposal was 'far more draconian than the version currently being used in the US and Switzerland' (Westlake, 2010). With all major banks opposed to a stringent leverage ratio, the Committee swiftly caved in to the industry demands. Following the IIF's advice, the Committee ruled out placing the ratio in Pillar 1 in the December 2009 reform proposals, stating that it would be a 'supplementary measure' until at least 2018 (BCBS, 2009: 60). In July 2010, meanwhile, the Committee announced that the ratio would be provisionally set at just 3 per cent, allowing banks to accumulate assets an enormous 33 times the value of their Tier 1 capital (BCBS, 2010a: 3).

Efforts to introduce a liquidity coverage ratio (LCR) and net stable funding ratio (NSFR), provisions aimed at ensuring that banks hold enough liquid assets to meet their short- and long-term funding needs, respectively, fared little better. After failing to influence the G-20 in July 2009 with claims that liquidity buffers would be 'counterproductive', the IIF stepped up its campaign against the measure following the release of the reforms package (IIF, 2009a: 52). In April 2010, the IIF attacked the stress scenarios used to calculate the LCR as 'implausible' and 'excessively restrictive', arguing for 'a more realistic approach, with the changes of assumptions that would follow from it' (IIF, 2010a: Annex 1, 6). It also urged the Basel Committee to expand its 'too-restrictive' definition of liquid assets under the LCR to include corporate and covered bonds. The IIF was equally critical of the NSFR, demanding that the 'unrealistic' factor used to discount retail deposits as a source of available funding be lowered and calling for the NSFR to be shifted to Pillar 2 because it was 'far from granular enough to support a highly prescriptive regime' (IIF, 2010a: Annex 2, 16). Remarkably, just months later the Committee fully embraced the IIF's recommendations. As well as instituting less demanding stress scenarios for the LCR, it permitted banks to count both corporate and covered

bonds as part of their portfolio of liquid assets under the ratio. The BCBS backtracked even further on the NSFR, stating that the measure ‘needs to be modified’ and promising to issue an entirely new proposal by the end of the year (BCBS, 2010a: 6). This proposal, contained in the final version of Basel III released in December 2010, both reduced the NSFR’s discount factor for retail deposits and confirmed that the ratio would remain in Pillar 2 until at least 2018 (BCBS, 2010c: 2, 27).

Finally, the Basel Committee’s proposal to introduce a capital surcharge for systemically important institutions was also substantially diluted during negotiations for Basel III. The IIF was the first to voice its concerns about the proposal, warning on the eve of the Pittsburgh Summit against ‘setting up artificial categories of systemic firms’ and emphasizing that any measures to address systemic risk be restricted to Pillar 2 (IIF, 2009b: 5). Unsurprisingly, the banking industry was not united in its opposition to the measure: Smaller institutions, seeking to neutralize the capital advantage enjoyed by A-IRB banks, have strongly supported a Pillar 1 surcharge for large banks. WOCCU, in particular, has argued that the interconnectedness of A-IRB banks ‘demands higher, not lower, capital requirements for large financial institutions, as the current calibration of Basel II suggests’ (WOCCU, 2010: 2). As with the continued use of internal ratings, however, these institutions arrived too late to influence outcomes. Before they had even registered their support for a Pillar 1 surcharge – the end of the comment period in April 2010 – the Basel Committee was already ‘deeply skeptical’ about the idea, in the words of one member, and had already begun developing approaches to incorporating it into Pillar 2.<sup>24</sup> Fears that the surcharge would be non-binding were confirmed in July, when the BCBS announced that it would develop a ‘guided discretion’ approach to setting capital requirements for systemically important institutions (BCBS, 2010a: 5). The calibration of the measure proved equally favourable to the largest banks. Despite suggestions by Federal Reserve economists that a robust surcharge should constitute up to 7 per cent of risk-weighted assets, in June 2011, the Committee opted to set it within a range of just 1.5–3 per cent (Tarullo, 2011; BCBS, 2011). Full implementation of the surcharge, meanwhile, would be delayed until 2019 (BCBS, 2011).

## CONCLUSION

The recent history of international banking regulation is one of failure after failure. Twice within the last 15 years, the Basel Committee has sought to strengthen global capital standards in response to an international financial crisis – and twice it has failed. Why has history repeated itself?

According to the dynamic analytical framework I have presented in this paper, the answer lies in the substantial information asymmetries

regarding the Basel Committee's agenda, which, combined with an opaque institutional context on the supply side, gave large international banks the crucial first-mover advantage in successive regulatory processes. This allowed them to shape decisions in a way that was near impossible to reverse at later stages. Latecomers, whether developing country banks or community lenders, had little choice but to accept what was in effect *fait accompli*.

Given the importance of robust capital regulation for the health of the global economy, it is crucial that we heed the lessons of this analysis. Future efforts to revise capital adequacy standards must both observe basic standards of due process and minimize the information asymmetries between stakeholders at each stage of the regulatory process – principally, but not exclusively, by maintaining a clear distance between supervisory bodies and the banking industry. Though difficult to achieve in practice, if implemented faithfully these changes would ensure that the next time regulators set out to revise global banking rules, they achieve every one of their aims.

As well as offering practical lessons for policymakers, my dynamic framework suggests a new direction for theoreticians. Scholars in the field of IR have traditionally analysed political phenomena through the narrow lens of comparative statistics. The case of international banking regulation shows that this reductionist approach is not always helpful. Drawing out and testing the causal implications of timing and sequencing are essential to a proper understanding of process-related politics. Students of global financial regulation and IR more broadly can reap enormous analytical gains from placing actors and events in their proper temporal context.

## NOTES

- 1 While there is substantial literature on the question of whether equity is *in theory* more expensive to issue than debt, most financial economists agree that the existing policy distortions entail that equity is indeed more costly. See Graham (2000).
- 2 In March 2009, the Basel Committee extended membership to all G-20 countries.
- 3 Core Tier 1 capital consists mostly of equity; Tier 1 consists of Core Tier 1 plus disclosed reserves; Tier 2 capital consists of undisclosed reserves, loan-loss provisions and subordinated debt.
- 4 Securitization is a way of financing a pool of assets. It involves transferring them to a third party conduit, usually a 'special purpose vehicle', which then issues asset-backed securities that are claims against the asset pool.
- 5 A 1998 survey found that the average Tier 1 capital of the largest 1,000 banks made up only 4.48 per cent of total assets, its lowest level since 1992. Cited in Wood (2005: 124).
- 6 The different aspects of credit risk include probability of default, expected loss given default, and exposure at default. Estimates are fed into a formula that determines the amount of capital that should be held against a given exposure.

- 7 The trading book is the portfolio of financial instruments that are purchased or sold on the stock market to facilitate trading for a bank's customers or hedge against risk.
- 8 Market risk is defined by the Basel Committee as 'the risk of losses in on- and off-balance-sheet positions arising from movements in market prices' (BCBS, 2004a: 157). VaR is the probability that losses on a portfolio of assets will exceed a certain amount within a given time horizon, for example \$1 million over the next 10 days.
- 9 See the House Financial Services Committee's comments in 2003 (Chaffin and Pretzlik, 2003).
- 10 Calculated with data from the Federal Deposit Insurance Company's 2008 Summary of Deposits, available at <http://www2.fdic.gov/sod/index.asp> (accessed 14 August 2009). The five banks are Bank of America, JP Morgan Chase, Wells Fargo, Citigroup and State Street.
- 11 Cf. George and Bennett (2005: 6).
- 12 Author's interview with Peter Cooke (Bank of England), Chairman of BCBS, 1977–88, Oxford, November 2008. The IIF was founded in 1983.
- 13 Author's interview with Oliver Page, former BCBS member (FSA), London, December 2008.
- 14 See the Global Accountability Report (Blagescu and Lloyd, 2006). The BIS has one of the lowest scores on its index of transparency, participation, and complaint and response mechanisms.
- 15 Author's interview with Patricia Jackson (Bank of England), former BCBS member, London, December 2008.
- 16 Author's interview with William McDonough (New York Federal Reserve), BCBS Chairman, 1998–2003, Washington, DC, January 2009.
- 17 Author's interview with Christopher Cole, Vice-President of ICBA, Washington, DC, January 2009.
- 18 Author's interview with anonymous BCBS observer (IMF), Washington, DC, January 2009.
- 19 Author's interview with anonymous BCBS member (FDIC), Washington, DC, January 2009.
- 20 Author's calculations. All the 10 largest banks by market capitalization had ratios of equity to total risk-weighted assets (an even narrower core Tier 1 ratio) of more than 9 per cent in 2007. Note that Basel III's 4.5 per cent minimum ratio is supplemented by a 2.5 per cent capital conservation buffer, which may be drawn upon during periods of stress (BCBS, 2010b: 2).
- 21 Other regulators have suggested similar figures. In March 2011, FSA Chairman Adair Turner remarked: 'If global regulators were benevolent dictators designing regulations for a banking system in a greenfield market economy, they would be wise to choose capital ratios far above even Basel III levels, something more like 15 per cent to 20 per cent of risk-weighted assets' (Masters and Braithwaite, 2011).
- 22 The Bank of England's Andrew Haldane has argued that the latitude in risk-weighting offered by internal ratings can lead to banks inflating capital ratios by 'several percentage points' (Haldane, 2011: 5).
- 23 Author's interview with Victoria Saporta (Bank of England), BCBS member, London, February 2010.
- 24 Author's interview with Andrew Haldane (Bank of England), BCBS member, London, February 2010.

## NOTES ON CONTRIBUTOR

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