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• GLOBAL ECONOMIC GOVERNANCE PROGRAMME •

Why Basel II Failed and Why Any Basel III is Doomed

Ranjit Lall

October 2009

GEG Working Paper 2009/52

Global Economic Governance Programme

Centre for International Studies | Department for Politics and International Relations

The Global Economic Governance Programme was established at University College, Oxford in 2003 to foster research and debate into how global markets and institutions can better serve the needs of people in developing countries. The three core objectives of the programme are:

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Abstract

According to conventional wisdom, the Basel II Accord – a set of capital adequacy standards for international banks drawn up by a committee of G-10 supervisors – is essential if we are to avoid another financial crisis. This paper argues that this conclusion is false: Basel II is not the solution to the crisis, but instead an underlying *cause* of it. I ask why Basel II's creators fell so short of their aim of improving the safety of the international banking system – why Basel II failed. Drawing on recent work on global regulatory capture, I present a theoretical framework which emphasises the importance of timing and sequencing in determining the outcome of rule-making in international finance. This framework helps to explain not only why Basel II failed, but also why the latest raft of proposals to regulate the international banking system – from the US Treasury's recent financial white paper to the latest round of G-20 talks in Pittsburgh – are likely to meet a similar fate.

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In the wake of the worst economic crisis of recent times, there have been widespread calls for better regulation and supervision of the international financial system. If more stringent regulatory regimes had been in place, one often hears, much of the reckless behavior leading to the crisis would never have occurred. One such regime is said to be the Basel II Accord, a set of regulatory proposals to govern the international banking system drawn up by the Basel Committee on Banking Supervision (BCBS), a group of G-10 supervisors. 'If we would have implemented Basel II', the current chairman of the Committee boldly claims, 'the world would have been different'.[1] Unfortunately, this is far from the truth. Basel II is not the solution to the current turmoil, but rather an underlying *cause* of it. While formal implementation began only recently, the accord has been shaping investment decisions since its publication in 2004 in a way that encouraged many of the risky lending practices at the heart of the crisis.[2] This is especially puzzling given the fundamental aim of the Basel Committee, when it set out to reform capital standards in 1999, of crafting an accord that *improved* the safety and soundness of the international banking system. In this paper, I ask why Basel II fell so short of the expectations of its drafters – that is, why Basel II failed. In answering this question, I also hope to explain why recent proposals to create a 'Basel III' – from the US Treasury's financial white paper to the latest round of G-20 talks in Pittsburgh – are likely to meet a similar fate.

Basel II's failure, I argue, lies in regulatory capture, 'de facto control of the state and its regulatory agencies by the 'regulated' interests, enabling these interests to transfer wealth to themselves at the expense of society'.[3] Large international banks were able to systematically manipulate outcomes in Basel II's regulatory process to their advantage, at the expense of their smaller and emerging market competitors and, above all, systemic financial stability. To understand why this happened, I present an analytical framework which sets out the broad conditions under which capture is expected to occur. My framework draws on what I call the 'neo-proceduralist' school of global regulation, developed in recent work by Walter Mattli and Ngaire Woods, which emphasizes two types of conditions. The first are so-called 'supply-side' conditions concerning the institutional context in which Basel II was drafted, and the second are 'demand-side' conditions concerning the extent of societal pressure for new regulation. I argue, however, that the neo-proceduralism can be strengthened as a theory of global regulatory processes by proper *temporal* contextualization. It is only by conceiving of capture as a process that unfolds over time that we can appreciate exactly how supply- and demand-side factors combined to give large international banks disproportionate influence over the Basel process. As it will later become clear, this theoretical innovation has implications that go beyond Basel II. It allows us to understand not only why the Basel Committee failed to achieve its objectives for the accord, but also why some of the more latest proposals in international banking regulation – despite the tremendous political will behind them – have enjoyed no more success. The failure of these proposals, my analysis warns, is very much a case of history repeating itself.

There are few areas of regulation as closely linked to broader macroeconomic stability and efficiency as banking regulation. Banks occupy a privileged position in the economy, as the basis of an efficient payments system and the main source of liquidity in the financial system. As Benjamin Cohen puts it, banks provide 'the oil that lubricates the wheels of commerce'.[4] To ensure that they can continue to perform this essential function – to ensure that the wheels of commerce keep spinning – banks must have the resources to withstand downturns in the economy. This is where capital regulation comes in. Over the past 25 years, capital adequacy

requirements have emerged as the dominant form of regulation for maintaining the safety of banks. The rationale for holding regulatory capital – mostly made up of shareholders' equity, reserves, and subordinated debt – against bank assets is to provide a buffer against unexpected losses and in the process to create a disincentive to undertaking excessive risks or shirking by bank owners and managers.[5] Where standards are not stringent enough, banks will not have sufficient capital to cover their losses. Liabilities will quickly come to outweigh assets, rendering them insolvent.

Unfortunately for banks, holding regulatory capital comes at a cost. They are forced to forgo the income that could have been generated from putting the same funds to profitable use. Rather than lying dormant, these funds could be lent to prospective borrowers to increase the bank's asset base, used to finance new projects, or returned to shareholders through increased dividends – any of which would boost returns on equity and give them a competitive edge over rivals. For banks with sizeable asset bases, a tiny percentage reduction in capital requirements can represent a saving of billions of pounds. As I show later, the incentive to minimize capital has proved too strong for these banks to resist. By hijacking the Basel process, large international banks effectively rewrote the rules of international capital regulation to give themselves free rein to set their own capital requirements. Even the ensuing economic turmoil has not deterred them, with powerful banking lobbies as we speak persuading supervisors to avoid a 'knee-jerk' response to the financial crisis. Understanding why these initiatives have failed to achieve the proper goals of capital regulation, then, has important implications for future efforts to create rules governing the international banking system and, by consequence, the future health of the global economy. Such an investigation will yield substantive conclusions about the conditions needed to produce banking regulation that serves the interests of society as whole, rather than the interest of those being regulated.

The rest of the paper proceeds as follows. Section II begins with a brief history of the Basel Committee and the transition from the first Basel accord to the second, before describing in greater detail the Committee's failure to achieve its stated aims for Basel II. In section III, I assess existing explanations of this failure, highlighting their analytical shortcomings. My main theoretical and empirical contribution is presented in section IV. While drawing on the 'neo-proceduralist' school of global regulation, I argue that only by injecting 'time' into its comparative-static framework can we fully understand the politics of international banking regulation. This is followed by a close examination of events leading up to the publication of Basel II, in which the hypotheses derived from my dynamic framework are tested through the method of process-tracing. Section V turns to some of the more recent regulatory initiatives in the area of capital adequacy. I argue that very same factors that caused Basel II's failure are now likely to prevent any meaningful progress in new proposals to raise international capital requirements – proposals to create, so to speak, a 'Basel III'.

II. The Failure

The Basel Committee of Banking Supervision was established in 1974 at the Bank for International Settlements (BIS), a meeting place for central bankers created after the First World War. Until very recently, the Committee consisted of members of the Group of Ten (G10) plus

Luxembourg and Spain, each represented by their central bank and the authority responsible for domestic banking supervision (where this is not the central bank).[6] The original mandate of the Committee was to deal with the regulatory challenge posed by the increasing internationalization of banking in the 1970s. The collapse of the German Herstatt Bank and the New York-based Franklin National Bank in 1974 showed that financial crises were no longer confined to one country, and that coordinated international action was needed to prevent future crises from spilling over borders. [7] The Committee's first proposal, the 1975 Basel Concordat, established rules determining the responsibilities of home and host country regulators vis-à-vis cross-border banks.

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

FIGURE 1: Definitions.

Capital Requirements	The amount of equity (Tier 1 capital), undisclosed and revaluation reserves, hybrid instruments and subordinated debt (Tier 2 capital) banks are required to hold against their assets to protect against insolvency, usually expressed as a ratio of capital to risk-weighted assets.
Securitization	A way of financing a pool of assets which involves transferring them to a third party conduit, usually a 'special purpose vehicle' (SPV), which then issues asset-backed securities that are claims against the asset pool.
Liquidity Facility	A credit line provided by a bank to investors in asset-backed securities in the event of a temporary shortfall in cash when conduits are unable to roll over paper.
Trading Book	The portfolio of financial instruments held by a bank which (unlike assets held in the banking book) are purchased or sold on the stock market, whether to facilitate trading for its customers or to hedge against risk.

Japanese banks, whose capital levels remained far lower.[8] In response, American regulators seized on the Basel Committee to establish a common framework for the capital regulation of internationally active banks, the 1988 Accord on Capital Adequacy (Basel I).[9]

The 1988 accord set minimum capital requirements based on a ratio of capital to risk-weighted assets of 8%. Assets were risk-weighted according to the identity of the borrower. Government bonds, for example, had a 0% risk weighting, while traditional corporate loans had a 100% risk

weighting, so that capital constituting the full 8% of the value of the loan must be held against it. Unlike later versions of the accord, Basel I only dealt with credit risk, the classic risk in banking of a debtor defaulting on his loan.

By the late 1990s, the accord had come to be seen as a blunt instrument that was 'useless for regulators and costly for banks'.[10] Bankers lamented the gap between the economic capital they felt they should hold to back loans and the regulatory capital assigned to these loans by the accord. Its crude risk weights entailed, for instance, that a loan to a secure blue chip company was treated the same as a retail customer's overdraft, or that a loan to a large industrial country received the same charge as one for to a volatile emerging market. This created perverse incentives to engage in regulatory arbitrage, exploiting the difference between economic risk and regulatory risk to reduce capital levels without reducing exposure to risk. Banks arbitraged Basel I's capital requirements in two ways.[11] First, they moved towards the riskier assets within a given risk weight category, which have a higher yield. Second, they shifted assets off the balance sheet, typically securitizing them. These assets were treated as 'true sales' for regulatory purposes, even though the bank often retained much of the underlying risk through credit enhancements such as liquidity facilities. 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.[12]

In September 1998 the Basel Committee announced that it would officially review the 1988 accord with the aim of replacing it with more flexible rules. In June 1999 it released its first set of proposals for the new framework. According to the Committee, the new accord would have the following objectives: (1) The Accord should continue to promote safety and soundness in the financial system and, as such, the new framework should at least maintain the current overall level of capital in the system; (2) The Accord should continue to enhance competitive equality; (3) The Accord should constitute a more comprehensive approach to addressing risks.[13]

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

The new accord was well received by bankers and regulators alike. Jean-Claude Trichet, Chairman of the G-10 group of central bankers, predicted that Basel II would 'enhance banks' safety and soundness, strengthen the stability of the financial system as a whole, and improve the financial sector's ability to serve as a source for sustainable growth for the broader economy'.[14] Indeed, there appeared to be strong grounds for optimism. Under the 'advanced internal ratings-based (A-IRB) approach' in pillar 1, banks for the first time were permitted to use their own models to estimate various aspects of credit risk, an innovation that would more closely align regulatory capital with underlying risk exposure and thereby reduce the incentives for regulatory arbitrage.[15] Those without the resources to operate in-house models, meanwhile, would adopt the 'standardized approach', essentially a more refined version of Basel I which linked more fine-grained risk categories to external credit ratings provided by commercial rating agencies. The new accord also made strides in the area of securitization, where the Committee proposed a

similar bifurcation of approaches, although this time with both approaches making use of credit ratings. Finally, Basel II had the significant merit of moving beyond its predecessor's focus on credit risk, tackling the previously unregulated area of market risk, 'the risk of losses in on and off-balance sheet positions arising from movements in market prices'.[16] In this area, banks were encouraged to use sophisticated models to produce estimates of 'value-at-risk' (VaR), the probability that the value of a given portfolio will decline by more than certain amount within a specified time horizon, for example £1m over the next ten days.

As surveys have emerged showing the likely effects of Basel II, however, it has become painfully clear that the accord has failed to achieve any of its stated objectives. With respect to the first objective, every official 'Quantitative Impact Study' (QIS) conducted by the Basel Committee forecasts large capital reductions relative to Basel I levels for banks employing the A-IRB approach. The 2006 QIS-4, for instance, shows these banks will experience an average drop in overall capital requirements of 15.5%, and a median reduction in Tier 1 capital of 31%.[17] Estimates by individual supervisors are no more encouraging. A 2003 study by the US Federal Deposit Insurance Corporation (FDIC) found that average capital levels in American banks adopting the most advanced approach would fall by 18-29%, with some seeing reductions of more than 40%.[18] Since the large banks likely to adopt this approach hold a significant share of the market, overall capital levels in the banking system are likely to decline, in explicit contradiction to Basel II's primary objective. On QIS-4 estimates, for instance, overall capital in the American banking system just prior to Basel II's formal implementation in 2007 would have fallen by as much as $220bn.

The accord has also failed to achieve its second stated objective, to continue to enhance competitive equality amongst banks. There are clear winners and losers under Basel II. Every QIS study shows large financial institutions under the A-IRB approach making significant gains on smaller institutions in terms of capital obligations. The 2006 QIS-5, for example, shows that A-IRB banks will experience a capital reduction of 7.1-26.7%, while those under in standardized approach will experience a 1.7% *increase* in overall capital requirements.[19] Under Basel II, these larger institutions will be able to free up capital and reallocate it to profitable areas, while other banks will be forced to undergo the opposite process. This is likely to reduce the profitability of smaller banks, causing a loss of market share, and making them more vulnerable to takeovers from larger banks. Indeed, a 2006 survey of over three hundred banks by Ernst and Young found that 75% believed Basel II would benefit the largest banks employing the most advanced risk modeling systems at the expense of those unable to adopt them.[20]

Finally, the accord cannot be seen to constitute a more 'comprehensive' approach to addressing risks. Provisions for risks associated with the trading book are conspicuously absent, despite the Committee's awareness that the size of banks' trading books had mushroomed as a result of Basel I. Even the treatment of new risks that the Committee *did* address was considerably watered down during the regulatory process. Banks were eventually allowed to use their own models to determine capital charges for market risk, even though market turmoil in the late 1990s had shown VaR models to vastly underestimate the probability of 'extreme' events. A similar shift towards self-regulation took place in the area of asset securitization, in spite of the Committee's recognition of Basel I's shortcomings in this area, as A-IRB banks were given permission to use their own estimates of the risk parameters for unrated exposures and liquidity

facilities. Equally concerning are the perilously low levels of capital Basel II stipulates for highly rated securitization tranches – precisely those positions that incurred the biggest losses in the sub-prime mortgage crisis. A-IRB banks, according to QIS-5, are likely to experience a fall in securitization capital requirements of up to 17.3%, a figure that also has serious implications for the safety and soundness of the banking system (objective 1) and for the competitive equality that the Committee had aimed to achieve (objective 2).[21]

Remarkably, the three objectives that formed the basis of the Committee's first consultative paper in 1999 were nowhere to be seen in the final version of the accord published in 2004. In their place are almost trivial new objectives, such as 'providing incentives to adopt more advanced risk-sensitive approaches of the revised framework' and paying 'due regard to particular features of the present supervisory and accounting systems in individual member countries' – objectives that the accord can more plausibly claim to achieve.[22]

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

III. Reviewing the Literature on Basel II

Academic discussion of Basel II has been largely confined to technical issues concerning the methodology for calculating capital requirements in Pillar 1 and its implications for the macroeconomic cycle. As a result, the politics of the Basel process have been somewhat neglected. Only a handful of scholars have sought to understand the range of actors, resources, and institutions shaping decision-making outcomes in the Basel Committee. The few attempts to tackle these issues show a regrettable failure to provide systematic and accurate analyses of the Basel process, and, above all, to explain the most salient feature of the process: the divergence between the aims of the Basel Committee and the final version of the accord.

We owe the most comprehensive examination of the politics of the Basel accords to Duncan Wood. In attempting to explain the 'driving forces' behind negotiations in the Basel Committee, Wood draws heavily on realist literature in the field of IR, focusing on the primarily on the distribution of power in the international economy and, specifically, the exercise of leadership by the United States .[23] As the most powerful member of the Committee, the United States has systematically pushed the interests of its domestic constituents ahead of its commitment to international financial stability. The result, argues Wood, is an accord skewed in favor of large American banks at the expense of other members of the Committee: 'The ability of the United States to obtain international agreements that reflects its interests and those of its banks has been the single most important factor in determining outcomes in the Committee.'[24] Unfortunately, this is far from the truth: there is little evidence of the United States playing the role of hegemonic leader that Wood casts for it. Indeed, American regulators have been heavily criticized in recent years by Congress for putting their own regional banks at a competitive

disadvantage – hardly the behavior of a hegemon bent on defending its national interests. [25] Basel II, contrary to Woods' assertions, does not promote the interests of individual members of the Basel Committee, but rather those of large international banks *regardless* of their national origin.

A very different analysis of the Basel process is offered by Magnus Bjerke, who poses the rather abstract question of 'What explains the making of Basel II?'[26] The answer, Bjerke argues, must appeal to a functionalist understanding of institutional outcomes. Whenever common regulatory standards are needed to address a systemic problem, the argument goes, an 'epistemic community' of public-spirited technocrats will mobilize to achieve international regulatory harmonization. In the case of international banking regulation, this group took the form of the Basel Committee, who re-emerged in the mid-1990s to neutralize the systemic threat of undercapitalization by introducing more risk-sensitive capital requirements. Despite its compelling logic, Bjerke's account fails to capture the true dynamics of the Basel process. As it will later become clear, the Committee neither played an instrumental role in the decision to revise Basel I, nor did they draw on their own technical expertise in drafting the accord, instead heavily relying on the advice from the private sector throughout the process. [27] Even more importantly, Basel II *failed* to neutralize the systemic threat of undercapitalization, leaving several banks on the brink of insolvency as losses began to emerge in the sub-prime mortgage crisis. Bjerke's functionalist account, unfortunately, sheds little light on the 'making' of Basel II.

A third and more promising analysis of the Basel process can be found in the work of Stephany Griffith-Jones and Avinash Persaud. [28] Griffith-Jones and Persaud seek to account for the inherent bias in Basel II in favor of large international banks and against lower rated sovereign, corporate, and bank borrowers – borrowers belonging disproportionately to developing countries. The explanation, they argue, is 'the excessive influence by the large financial institutions domiciled in the countries represented on the Committee. The new accord is to their benefit and to the detriment of emerging market borrowers and developing countries not represented on the Committee.'[29] With no formal representation on the Basel Committee, then, developing countries were forced to accept what was in effect a pact between G-10 nations. By drawing attention to the possibility of regulatory capture, Griffith-Jones and Persaud takes an important step towards explaining why regulators, despite setting out with the best intentions, may in the end fail to achieve their aims. Having said that, they stop short of presenting a full framework for the analysis of capture; the argument they present amounts to little more than an assertion of capture. As such, the authors fail to systematically spell out the conditions under which capture occurred. In their absence, no firm conclusions can be drawn about the causes of Basel II's failure. In the next section, I outline a framework that sets out these conditions.

IV. Explaining the Failure of Basel II

Overview of the analytical framework

The point of departure for my analytical framework is Walter Mattli and Ngaire Woods' recent work on the politics of global regulation.[30] Mattli and Woods set out the broad conditions under which different regulatory outcomes are expected to occur in international rule-making, suggesting a plausible set of hypotheses about the factors facilitating capture in the Basel process. I argue, however, that the comparative-static analysis presented by the authors fails to

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

Mattli and Woods start by drawing the distinction – only hinted at by Griffith-Jones and Persaud – between regulatory change that serves the common interest and regulatory change that benefits narrow vested interests as a result of regulatory capture. To understand when regulatory processes are more likely to produce one kind of change rather than the other, they argue, we must understand the institutional context in which rules are drafted, implemented, monitored, and enforced. An 'extensive' institutional context, characterized by open forums, proper due process, multiple access points, and oversight mechanisms, is less liable to be captured than a 'limited' institutional context that is exclusive, closed, and secretive. In this respect, Mattli and Woods have much in common with international legal experts, particularly in the emerging field of global administrative law, who represent the core of the 'proceduralist' school of global regulation.[31] For these scholars, the public interest is identified with a certain kind of regulatory process, namely one which meets certain standards of due process. As Mattli and Woods put it, 'regulation is said to be in the public interest if it is arrived at through a deliberation process that allows everyone likely to be affected by it to have a voice in its formation'.[32]

Affinities with the proceduralist school, however, end here. Mattli and Woods reject the idea that improvements on the institutional front alone are sufficient to secure common interest regulation. In addition to these supply-side conditions, certain 'demand side' conditions must be satisfied in order to produce optimal regulatory outcomes. First, constituencies adversely affected by the regulatory status quo must have proper information about both the social cost of capture and the international regulatory agenda. Where powerful market players have a monopoly on information, whether through better organization or personal contacts with regulators, they will have little trouble securing their preferred outcomes. Second, these constituencies must be supported by public or private 'entrepreneurs' providing technical expertise, financial resources, and an organizational platform for them. Finally, and crucial to the success of public-private alliances, is a shared set of ideas about how to regulate around which diverse actors can unite in a pro-change coalition.

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

By moving beyond the naïve assumptions of proceduralism, Mattli and Woods have undoubtedly advanced the study of international regulatory processes. What they have failed to do, however, is identify the salient causal mechanisms that link supply- and demand-side factors to regulatory outcomes. To identify these mechanisms, we must pay attention to key *temporal* dimensions of regulatory processes that are lost in the 'snapshot' view of comparative-static analysis. In other words, we must conceive of capture as a cumulative process that unfolds over time – and not one that occurs in decontextualized isolation. The analytical gain from this shift in focus is

significant: recognizing that events or processes are rooted in a particular temporal context sensitizes us to crucial causal effects that are essentially invisible from an ahistorical point of view.[33] The introduction of time into the framework, then, will allow us to preserve the important insights of the neo-proceduralist framework while at the same time constructing more accurate hypotheses about supply- and demand-side variables in the Basel process.

What exactly do we gain from contextualizing the framework? The answer lies essentially in the demand-side of the framework. Recognizing that regulatory processes take place in time gives us a better understanding of how actors with a comparative informational lead are able to convert this advantage into concrete regulatory outcomes. Specifically, the reason that the better-informed are able to exercise such a disproportionate degree of influence over the regulatory process is that they are able to claim 'first-mover advantage' – they are the first to arrive at the decision-making table. This gives them enormous leverage at critical junctures in the regulatory process, since policy decisions made at an early stage tend to be self-reinforcing. Once a particular path has been chosen, we are often reminded by economists, each step down that path increases the probability of further steps, as the relative benefits of the current activity compared with once-possible options increases over time. It becomes more and more difficult, meanwhile, for latecomers to reverse the trend. As Paul Pierson argues, 'If early competitive advantages may be self-reinforcing, then *relative timing* may have enormous implications…groups able to consolidate early advantages may achieve enduring superiority. Actors arriving later may find that resources in the environment are already committed to other patterns of mobilization.'[34] In the case of Basel II, then, our neo-proceduralist framework leads us to expect those with the best information about the Basel Committee's agenda – large international banks – to gain first-mover advantage in negotiations for the new accord, allowing them to shape decisions in a way that is increasingly difficult to reverse at later stages.

Having good information, however, is not the same as having abundant material resources. In the case of Basel II, for instance, the five or so American banks with the greatest influence on the accord – through their pre-eminent position in powerful international banking lobbies – had a combined deposit market share of only 36% in the United States.[35] It was not their resources per se that were key to their success in shaping the accord, but, as it will later become clear, the timing of their involvement in the regulatory process – a very different kind of advantage that was based on the personal contacts they had amongst regulators. In this respect, my analysis is not just a thinly veiled recourse to realism. Nor is it a recourse to historical institutionalism. The question of who arrives first is not a matter of chance, but a function of the distribution of information amongst actors. More importantly, unlike scholars like Pierson, I do not take 'time' to be an analytically salient variable in *all* circumstances. Early participation only matters under certain conditions, namely when negotiators have little accountability to domestic constituents – almost always the case in technical matters such as capital adequacy standards. First-mover advantage is of little consequence, on the other hand, in the more familiar 'grand bargains' between states in the realms of security and trade. Here, in Robert Putnam's famous formulation, negotiators are subject to a crucial constraint: any agreement they reach must be endorsed by their constituents in a separate 'ratification phase'.[36] This effectively nullifies any advantage gained from early participation, since any deal reached by negotiators can be later rescinded by concerned domestic groups. Spelling out the conditions under which first-mover advantage matters, therefore, is not to deny the importance of organized lobbying power in global

regulatory processes; rather, it is to explain what this power *is* in the different institutional contexts in which rule-making takes place.

To summaries, the central claim of my analysis is that neo-proceduralism can be strengthened as an analytical framework of global regulatory processes by proper temporal contextualization. Where agreements reached at the international level are subject to domestic ratification, each party's timing has little import. But where agreements lack a distinct ratification phase, timing takes on enormous significance. In the case of Basel II, large international banks are expected to use their privileged access to information about the Basel Committee's agenda to arrive first at the decision-making table and influence the content of the accord at a critical stage of proceedings. Those arriving later will struggle to have any bearing on negotiations, facing an increasingly entrenched set of proposals. It should be noted that contextualizing the framework does not render supply-side factors irrelevant to the analysis. A lack of due process, after all, can disadvantage public groups as much as a lack of early information, leading to capture regardless of how well-informed they may be. The point merely is that institutional context alone cannot explain why a select few banks were able to skew Basel II so heavily in their favor. This is something we can discover only by introducing the concept of time into the neo-proceduralist analysis, and something we can test only through a detailed investigation into how the Basel process unfolded. This is what I turn to in the next section.

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

In order to test my account of Basel II's failure, I propose to use the method of process-tracing. A close examination of Basel Committee documents, press releases, interview transcripts, and other sources will help to determine whether the specific causal mechanisms implied by the theory are in fact evident in the sequence of events comprising the Basel process.[37] The first part of the section focuses on the Basel Committee's failure to achieve its first and second aims for the accord, the result of its decision to allow wealthy banks to use internal ratings. The second part will turn to the third aim, and the related developments in the treatment of market risk, the trading book, and securitization that caused Basel II to fall short of providing a more 'comprehensive' approach to risk management. The third and final part will offer evidence from the subprime mortgage crisis of the very real social cost of Basel II's failure, illustrating the devastating consequences of captured capital regulation.

Before the investigation begins, a word on institutional context. As suggested in the previous section, although the analytical framework I presented emphasizes demand-side factors, it is nevertheless important to be aware of the institutional setting in which the Basel process took place, and the role that the supply-side played in reinforcing power asymmetries created on the demand-side. In short, the Basel Committee has one of the worst records of all international standard-setters in terms of transparency, representation, and accountability.[38] The Committee's meetings (which occur four times per year) are closed to the public, with no record of who was present or what was discussed.[39] The frequent discussions with outside interests, in particular the banking industry, were also off-the-record and took place on a relatively informal basis. It is much the same story for subcommittee meetings. Under the main Basel Committee, there are four policy groups in charge of fourteen subcommittees working on different aspects of the accord. [40] It is in these subcommittees that much of the technical work is done, often in close

consultation with industry experts. Despite their importance, it is only recently that *any* information has been disclosed about these committees, and even this is limited to the name of the group, its chair, and its position in the organizational chart.[41]

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

Finally, few mechanisms exist for holding the Basel Committee to account. Unlike organizations like the United Nations, there are no post-facto accountability exercises which allow public groups to question the Committee's success in terms of its own goals. Indeed, because its members are drawn from regulatory agencies rather than governments, they are relatively insulated from executive and legislative control domestically. Once appointed, they tend to have a high degree of operational independence, and are typically subject to little legislative oversight. At the international level, the Basel Committee answers only to a group of G10 central bank governors, eight of whom have either no responsibility for banking supervision or only a supporting role.[42] Only recently have the governors convened a group of heads of supervision, and this is only as an advisory group. Even members of the Committee have expressed reservations about this arrangement. Howard Davies and David Green, for instance, lament that the G10 Governors have been more concerned with guarding their control of the Committee than monitoring its activities, insisting that its chair be a central bank governor even if there is none with appropriate experience and domestic responsibilities.

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

Internal ratings

The Basel Committee's decision to create an A-IRB approach to credit risk represents perhaps the clearest example of regulatory capture in the Basel process. It should be clear by now that the attraction of internal ratings for large international banks lies in their perceived impact on capital requirements. For two reasons, internal ratings are likely to lead to large capital reductions for banks employing them. First, they are largely derived from historical data, which suggest that the capital that should be held against certain types of assets is much lower than that stipulated by Basel I. The problem with this method of calculation is that the historical default rates of asset classes are often not a good indicator of their future default rates.[43] Indeed, during financial crises assets which were previously uncorrelated tend to become correlated, generating much larger losses than anticipated. Second, despite being introduced to reduce regulatory arbitrage,

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

The decision to create an approach based on internal ratings was heavily influenced by developments in the initial stages of the Basel process. At the centre of these developments was the Institute of International Finance (IIF), a powerful consultative group of major US and European banks based in Washington. The institute had long enjoyed a close working relationship with the Basel Committee based on its personal contacts in national regulatory agencies. Indeed, the first and longest-serving Chairman of the Basel Committee, the Bank of England's Peter Cooke, was in fact one of the co-founders of the IIF.[44] The man presiding over the Committee's work on Basel II, the Federal Reserve of New York's William McDonough, also had close links with the banking industry. McDonough had a 22-year career at the First National Bank of Chicago before chairing the Basel Committee, and was a close associate of Charles Dallara, Managing Director of the IIF since 1993.[45] As a result, the institute enjoyed privileged access to the Committee from the earliest stage of the reform process, even going as far as to establish a Steering Committee on Regulatory Capital in June 1999 specifically to make recommendations about Basel II. It remained the Basel Committee's principal interlocutor throughout negotiations, with its two working groups helping many of the Basel subcommittees to draft different parts of the accord. Clearly, large international banks benefited enormously from early access to the Basel Committee. Even by the Second Consultative Paper in 2001 the IIF was able to identify seven different areas in which the Basel Committee had adopted its recommendations.[46]

One of these areas was the introduction of an internal ratings-based approach to credit risk. The IIF had lobbied aggressively for greater recognition of banks' own risk measurement systems from November 1997. These systems, the group argued, were not only more risk-sensitive than Basel I's arbitrary risk weights, but had the crucial advantage of being already in use by banks.[47] This proposal was initially met with skepticism by regulators. At the September 1998 conference at which the Committee announced its agenda for revising Basel I, Bank of England staff stated that there were 'significant hurdles' to using internal systems to set capital requirements.[48] Similarly, a study by two Federal Reserve economists found the state of ratings systems in large American banks far less advanced than had been widely assumed.[49] Nevertheless, by the release of the first consultative paper for the new accord the IIF had succeeded in convincing enough of the Committee of the merits of an A-IRB approach to credit risk for 'some sophisticated banks'.[50] There were, however, only a few paragraphs devoted to the idea, and the focus of the paper was how *external* ratings provided by credit rating agencies would be formally incorporated into the accord. What changed between the release of the first paper in June 1999 and the second in January 2001, in which a full specification of a new A-IRB approach was given?

The answer lies in the persistent lobbying of the IIF, which took advantage of its intimacy with the Committee to ensure that the advanced approach, almost an afterthought in the first paper, became a reality. During 2000, the Steering Committee published a report specifically urging the Basel Committee to permit banks to use their internal risk rating systems as a basis for assessing capital requirements. Sir John Bond, then Chairman of the IIF, suggested that the measure was

'important for enhancing the competitiveness of banks by bringing individual banks' capital requirements more in line with actual risks'.[51] Revealingly, a credit risk manager at the UK's Financial Services Authority (FSA) at the time admitted that 'more regulators around Europe are coming round to the view that a large number of banks should be able to qualify for internal ratings'.[52] By mid-2000, it seems, every member of the Basel Committee had come around to the IIF's view, and the working group on credit risk began informal work with the IIF to incorporate internal ratings into the new framework.[53] The second draft's detailed exposition of the A-IRB approach was 'broadly welcomed' by the IIF's Steering Committee as one of the many areas in which its recommendations had been taken on board.[54]

By the time small and non-G10 banks became aware of the likely impact of these developments, the release of the second consultative paper in 2001, negotiations were at such an advanced stage that an overhaul of the Committee's proposals was near impossible. As the vice president of ICBA, a leading association of American community banks, put it, 'We didn't get involved until quite a late stage…And when we did, the modeling (A-IRB) approach was already seen as the way to go. The [Basel] Committee had been convinced by the large banks.'[55] The few comments left by small banks reflected serious apprehension about the potential competitive inequities of Basel II. Amongst the loudest voices were the Second Association of Regional Banks, a group representing the Japanese regional banking industry, and Midwest Bank, an American regional bank catering to consumers in Missouri, Iowa, Nebraska, and South Dakota. The latter protested that the few banks qualifying for the A-IRB approach 'will not be required to keep the same level of capital against financial instruments as 99% of the financial institutions in this nation who cannot qualify under these standards'.[56] These concerns were perhaps best expressed by America's Community Bankers (ACB), another group representing community banks across the United States. The ACB made a strong case for the claim that 'the Accord will benefit only the most complex and internationally active banks, saddling the vast majority of financial institutions in the United States with a cumbersome and expensive capital regulatory scheme…'[57] This was most pronounced, the group claimed, in Pillar 1, where 'the proposed bifurcation between the Standardized and internal ratings-based approaches to establishing minimum capital requirements will competitively disadvantage many smaller banking institutions that lack the resources necessary for developing a finely calibrated IRB assessment system'.[58]

Competitive fears were not confined to community banks. Several important emerging markets also expressed fears that they would be disadvantaged under the new arrangements. Commenting on the 2001 second consultative paper, the Reserve Bank of India complained that, by failing to qualify for internal ratings, emerging market banks would experience a 'significant increase' in capital charges.[59] The People's Bank of China, meanwhile, suggested that the proposals 'basically address the needs of large and complex banks in G10 countries'.[60] Similar worries were articulated by the Banking Council of South Africa, which pointed out that while 'the Accord aims at 'competitive equality', the bigger, more advanced banks may have access to options that will give them a market advantage, whereas the smaller banks may find it difficult to afford the necessary infrastructure investments'.[61] Like the objections of community banks, however, these came too late to influence proceedings. The idea of discarding years' worth of work on developing the A-IRB approach could not be taken seriously, especially by a Committee already under fire for delaying the implementation of Basel II. It is no surprise that when a group

of 5 major emerging markets protested about the accord's competitive implications at a behind-closed-doors meeting in Cape Town in 2002, it was accused by Chairman McDonough of attempting to 'derail the whole process'.[62] By this stage the recognition of internal ratings was a well established feature of Basel II. Indeed, only very minor changes were made to Pillar I's credit risk approaches between 2001's second consultative paper and the final version of the accord published in 2004.

Trading book, market risk, and securitization

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

Basel II's light treatment of the trading book had much to do with the International Swaps and Derivatives Association (ISDA), the largest global financial trade association, representing over 860 institutions in the privately negotiated derivatives industry. As one of the first organizations to comment on drafts of the new accord, the ISDA managed to persuade the Committee to defer to its 'better' judgment on several trading book issues, most importantly in its September 2001 decision to drop its initial proposal for an additional capital charge to cover credit derivatives risk. The ISDA had forcefully lobbied against the measure, dubbed the 'w factor', on the grounds that it was 'unjustified in light of market practice: losses experienced on repo or credit derivatives trades had been minimal, and the contracts used to document the transactions were enforceable and effective'.[63] The Committee's reversal, as the *Financial Times* noted at the time, was at odds with concerns recently expressed by its members about the way banks were dealing with exposure to the derivatives market and the possibility that the structure of these instruments tended to *concentrate* risk rather than dispersing it, as they are in theory meant to do.[64]

The ISDA also had a hand in the Committee's reluctance to regulate those trading book risks that were not captured by standard market risk models, in particular default risk. The Committee's trading book working group, which worked closely with the ISDA, bought into the association's argument that 'the assumptions regarding the calibration of credit risk requirements in the banking book may not be appropriate for trading book exposures, which are typically short-term in nature, more liquid, and marked-to-market'.[65] As one former member of the Committee admitted, 'We went too far on capital relief for the trading book. We were convinced by the industry that [instruments in the trading book] needed a lower capital charge because they were more liquid…In good times, it's hard to go against the banks.'[66] The subprime mortgage crisis has shown this argument to be fatally flawed, with the heaviest losses on highly illiquid and opaque trading book instruments. In the end, the section devoted to the trading book was one of the shortest in the 2004 final accord. Accusations of regulatory forbearance, which grew louder in 2004, once again came too late. [67] While the Basel Committee was forced to admit that increased capital charges for trading book risks were needed, given 'the complexities of the trading book issues to be discussed', it was willing only to defer reform to a later date.[68]

The only aspect of the trading book the Committee made a concerted effort to tackle was market risk, albeit in the mid-1990s rather than during official negotiations for Basel II. Even in this area, though, proposals were significantly watered down in the face of industry pressure. In

1993, the Committee proposed to amend the 1988 accord to incorporate market risk, largely in response to the deregulation of interest rates and capital controls, which had increased banks' vulnerability to market fluctuations. The 1993 paper proposed a standardized methodology for measure market risks which calculated capital requirements on the basis of certain characteristics of debt securities and derivatives, such as maturity, credit rating, and category of borrower.[69] These proposals were met with strong opposition from the IIF, who maintained that they failed to provide sufficient incentives to improve risk management systems by not recognizing the most sophisticated modeling techniques already in use.[70] The IIF was soon joined by the Group of Thirty, a Washington-based association of senior bankers, which backed VaR models as 'much more analytically rigorous than the old rules of thumb that bankers used to use'.[71] The Committee soon yielded to these demands, investigating the possible use of the banks in-house VaR models throughout 1994, and officially recognizing them in April 1995.[72]

This was a surprising development given the 'quite disparate' results from the Committee's testing exercise, which showed significant overall dispersion in capital charges for the same trading book even after the apparent factors causing systematic differences in model output were controlled for.[73] It was also surprising given the serious doubts about these models that began to surface in 1995, such as the rating agency Standard and Poor's warning in 1995 that although the models 'appear to offer mathematical precision…they are not a magic bullet'.[74] Most surprising, though, was the fact that these models passed into Basel II without question. At the time the Committee was formulating its first draft accord in early 1999, banks were reporting widespread losses on Russian government bonds that were entirely unanticipated by their VaR models. Bankers Trust, an American wholesale bank, reported that on five days during the latest quarter its trading account losses had exceed its one day 99% VaR calculation, a figure that statistically should be exceeded on just one day in a hundred.[75] J.P. Morgan, too, reported that daily trading results had fallen below average far more often than its market risk models had predicted. Most damningly, a report published by the International Monetary Fund (IMF) in December 1998 had condemned VaR models for paying 'insufficient attention' to extreme market events and assuming that the processes generating market prices were stable. [76] But despite widespread and persistent criticism, no questions were raised within the Committee about the continued use of VaR models in 1999.

Basel II's failure to create a more comprehensive approach to risk management also stemmed from its lenient treatment of asset securitization. Assigning a suitable capital charge for asset-backed securities was high on the Basel Committee's list of priorities, not least because of their central place in the 'originate and distribute' model so effectively employed by banks to arbitrage Basel I's capital standards. Once more, however, the Committee's initial tough stance was gradually eroded by determined industry groups. The earliest arrivers, which worked closely with the Committee's working group on asset securitization, were large forums for banks specializing in the trade of off-balance sheet instruments, in particular the European Securitization Forum (ESF), the American Securitization Forum (ASF), and the ISDA.[77] These forums convincingly argued that securitization facilitates prudent risk management and diversification by providing an efficient means for banks to redistribute their risks to those most willing to bear them. Securitization, the ESF claimed, 'has proven itself to be a source of safe, fixed income assets from the perspective of banks as investors'.[78] The credibility of these claims, of course, has been shattered by the subprime mortgage crisis. Nonetheless, the Committee

heavily diluted its securitization proposals during negotiations for Basel II, requiring progressively less capital for the same exposures and allowing banks to set capital charges in several areas on the basis of internal ratings. It even began to adopt the securitization industry's language, reiterating in several proposals that 'the Committee recognizes that asset securitization can serve as an efficient way to redistribute the credit risks of a bank to other banks or non-bank investors'.[79]

In its first draft in 1999, the Basel Committee proposed to directly tie capital charges for securitization tranches to external credit ratings. For all banks, tranches rated AAA or AA- would carry a 20% risk weight, A+ to A- a 50% weight, BBB+ to BBB- 100%, BB+ to BB- 150%, and B+ or below a deduction from capital. The Committee was soon persuaded by the ESF to devise a separate approach for A-IRB banks to 'take advantage of the greater capacity for risk-sensitivity under the internal ratings-based framework'.[80] Outlined in the 2001 second consultative paper, an advanced approach would permit banks to use their own estimates of probability of default for unrated exposures. Further steps towards self-regulation were taken January 2004, as the Committee acted on the forums' request for an internal ratings-based approach for liquidity facilities extended to asset-backed commercial paper conduits.[81] 'It is evident', said a member of the ESF and ASF's regulatory committees in March 2004, 'that [the Basel Committee] have been listening. At the start of the process there were some hurdles…' – hurdles which no doubt had been which successfully negotiated.[82] Both of these measures, however, gave A-IRB banks further scope to game capital requirements and gain a competitive edge on smaller banks, enhancing the privileged position already conferred on them by low credit risk requirements.

Figure 2: Initial aims and regulatory outcomes

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

The approach's treatment of *rated* positions, however, was the subject of intense industry opposition from an early stage. In 2001, the ESF complained that the prescribed risk-weights for rated tranches were 'excessive', arguing that they should never be higher than identically-rated conventional corporate exposures.[83] After the IIF stepped in to back the ESF's claim, protesting that the 'proposal's recommended treatment of securitization activities is too stringent and risks disrupting the valuable aspects of existing activities', the Committee acquiesced, almost halving the risk-weights for rated tranches to link them with corporate exposures with similar default probabilities.[84] In the next two years, further reductions were made to the risk weights after consultation with the securitization forums, reflecting the risk-mitigating effects of features such as 'pool granularity' that the Committee's own specialists had apparently overlooked. By the final paper in 2004, they had reached dangerously low levels. Risk weights for the senior positions of tranches rated AAA would be 7%, AA 8%, A+ 10%, A 12%, BBB+ 35%, and BB 60%. The risk weights for rated tranches under the standardized approach, meanwhile, remained the same as in the 1999 first draft. This was a startling reversal. The inadequate treatment of securitization, after all, was one of the main motivations for updating Basel I in the first place. It

is hard to resist the conclusion that, had a different set of actors had been first on the scene, securitization proposals would have reflected a much broader set of preferences.

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

Systemic evidence of the failure of Basel II

What was the social cost of Basel II's failure? In this section, I adduce evidence from the subprime mortgage crisis illustrating the devastating consequences of capture in international banking regulation. Starting in the United States' subprime mortgage market in summer 2007 and quickly spreading to Europe, the crisis has passed perhaps the most damning verdict of all on Basel II. Far from helping to avert the crisis, the accord in fact directly contributed to it, providing strong incentives to engage in many of the risky lending practices that led to its outbreak. This evidence is the final chapter in my account of Basel II's failure, demonstrating that concessions made to large international banks during negotiations were *not* efforts at improving the efficiency of the banking sector based on sound industry advice, but instead quintessential examples of regulatory capture.

While an explanation of the subprime mortgage crisis is well beyond the scope of this article, for our purposes here we need to be aware of only one factor which has been unduly neglected in analyses of the crisis: the inadequate capital regulation provided by Basel II. This may seem counterintuitive. Legal enforcement of the accord, after all, only began in 2007 in Europe and is yet to begin in the United States. But it would be naïve to tie the effects of Basel II too closely to its formal implementation date. Banks began to incorporate the regulatory changes implied by Basel II into their growth strategies well before the summer 2007 outbreak of the crisis. Several were undertaking parallel runs from 2005 to see how they would be affected by the changeover, while others complied with Basel II standards as part of QIS-4, initiated in October 2004. The following quote from a senior investment banker is particularly revealing: 'We started looking at the implications of Basel II from the day it was published back in 2004. Changes like these have huge implications for our business, so you can't just leave them to one side until the system is up and running…We have been looking at this and adopting anticipatory strategies for at least four or five years.'[85] Unfortunately, many of these 'anticipatory strategies' were directly involved in the outbreak of the financial crisis.

Three are particularly salient. The first strategy was to concentrate bank lending in the mortgage sector, which added fuel to the housing bubble set off by low US interest rates. This was a response to the reduced risk weights for residential mortgages under all approaches of Basel II: for standardized banks, mortgage risk weights are cut by 15%, while for A-IRB banks the drop can range anywhere from 60% to 90.[86] It is no coincidence that on-balance sheet mortgages rose

by 6% of GDP in the United States from 20% at the time of Basel II's publication in 2004 to 26% in March 2008.[87] Banks with retail-oriented portfolios were left vastly undercapitalized, becoming them insolvent very soon after losses began to emerge from sub-prime mortgages. The collapse of British mortgage lender Northern Rock is a case in point. As Adrian Blundell-Wignall and Paul Atkinson have recently shown, Northern Rock's failure was preceded by a few years of aggressive expansion and a concentration of assets in mortgage products, which eventually made up 75% of their asset base.[88] When asked why the lender decided to increase the dividend in July 2007, a time when it was hugely overleveraged, CEO Adam Applegarth responded: 'Because we had just completed our Basel II two-and-a-half year process and…it meant we had surplus capital and therefore that could be repatriated to shareholders through increasing the dividend.' [89] Once Northern Rock adopted the advanced approach in June 2007, its risk-weighted assets almost halved, implying a commensurate decline in capital. At the time of its collapse, despite complying with Basel II, the lender held capital amounting to a mere 2% of total assets.

A second anticipatory strategy adopted by banks aimed to exploit Basel II's reduced capital charges for off-balance sheet exposures. As shown in the previous section, accord assigns negligible risk weights to rated securitization tranches, as low as 7% for AAA-rated exposures. This gave banks a strong incentive to stockpile off-balance sheet instruments in large quantities after 2004 in anticipation of massive capital relief when the new rules came into force. Asset-backed securities grew even faster than on-balance sheet residential mortgages, rising from 7% of US GDP in March 2004 to a peak of 18% in June 2007 – a greater increase in the three years after Basel II's publication than in the entire previous twenty years. [90] Citibank, which wrote off $42bn worth of sub-prime-related assets during the crisis, is an interesting example. In 2003, its proceeds from mortgage securitizations were $71bn, and in early 2004 they actually *fell*. Following Basel II's release in mid-2004, however, proceeds accelerate sharply, reaching $147bn in the space of three years.[91] Once losses began to emerge, the thin slice of capital retained against these exposures was eroded, causing institutions like Citibank to 'deleverage' and capital markets to dry up as a source of funds. Contrary to claims by current Chairman Nout Wellink, the accord resoundingly failed to create more neutral incentives between retaining an exposure on the balance sheet and distributing it in the market through securitization.

The final, and perhaps most fatal, strategy adopted by banks was the excessive reliance on market risk models to calculate capital requirements for the trading book. Unlike the previous two, this strategy was not strictly speaking anticipatory, since the Basel Committee had officially recognized internal VaR models in the mid-1990s (see section IV). This was to prove a fateful decision. VaR models systematically underestimated market risk in the run up to the subprime mortgage crisis, spurring traders to take on excessively risky positions without sufficient capital to cover exposures .[92] The FSA's recent analysis of the crisis, the 'Turner Review', finds that market risk capital typically accounted for less than 10% of a bank's total capital, even though trading book assets represented as much as 57% of total assets.[93] This translated into an average market risk capital requirement of well under 1% – inexcusably low given the actual risk entailed by these assets. Given the well-known flaws inherent in VaR models, such as their erroneous assumption of a normal distribution of asset returns and their neglect of other kinds of risks associated with the trading book (default risk, credit migration risk, credit spread risk, equity price risk), it is remarkable that they were ever adopted.

For strong evidence of Basel II's high social cost, then, we need only look at the current state of the global economy. While the accord was not the only contributor to the financial crisis, it played no small role in encouraging the reckless lending practices at the heart of the crisis by shaping investment decisions prior to its legal implementation. Changes made by the Basel Committee during negotiations were not efficiency-improving innovations, but barely concealed measures to enhance the profitability of large banks at the expense of their smaller rivals and society as a whole.

V. Implications for the Fate of 'Basel III'

It is perhaps no surprise that Basel II has been subject to the some of the most scathing criticism to come out of the financial crisis. Politicians, bankers, and even regulators have turned on the accord, with the Chairman of the FDIC condemning the 'capital-lowering bias that is essentially baked into the advanced approach', and Alan Greenspan, a long-time advocate of deregulation, accusing the Basel Committee of creating 'a set of capital rules that failed to foresee the need that arose in August 2007 for large capital buffers'.[94] Indeed, something of a consensus has emerged in the international regulatory community that insufficient capital levels in large banks were a major contributor to the crisis. In the 2008 Washington Declaration, G-20 nations noted the build-up of 'excessive leverage' in the global financial system and pledged their full commitment to maintaining higher capital requirements for the sake of future financial stability.[95] The US Treasury Secretary Timothy Geithner has declared the three most important remedies to the financial system to be 'capital, capital, and capital'.[96] Remarkably, though, 'Basel III' is nowhere in sight. In the two years since the crisis erupted, the Basel Committee has shown a distinct reluctance to address any of the serious deficiencies in Basel II, while international supervisory bodies have produced little more than vague recommendations about increasing capital requirements in the future. Is history repeating itself? What does our neo-proceduralist framework have to say about the fate of the post-crisis initiatives?

In this section, I argue that the very same factors that led to Basel II's failure are now likely to prevent any meaningful progress in post-crisis efforts to raise international capital requirements. Despite the tremendous political will behind more stringent standards, it is once again large international banks that are dictating the regulatory agenda, effectively closing the window of opportunity for reform. As the neo-proceduralist analysis predicts, this is the consequence of both the relatively exclusive setting in which regulatory initiatives have been debated and the superior information about these initiatives possessed by institutions like the IIF, ISDA, and ASF, which has allowed them to claim first-mover advantage in domestic and international regulatory processes.

The origins of this advantage lie in the first months after the outbreak of the financial crisis in July 2007. As regulators frantically searched for the cause of mounting losses on mortgage-backed securities, banking groups were already taking steps to protect themselves from a potential regulatory backlash. As early as October 2007, senior members of the IIF spent a weekend in Washington 'lavishing central bankers…with praise, awards, and banquets, including taking over a museum for the night to dazzle them with a private circus'.[97] The clear message from the financial community, it was noted at the time, was that banks should take the

lead role in dealing with the crisis, and that official action should only come if there were issues the private-sector could not resolve itself.[98] Even at this early stage the IIF's efforts seemed to be paying off. According to the *Financial Times*, a 'genuine warmth' had developed between bankers and regulators who had collaborated over the past two months to formulate a response to the crisis. Jean Claude Trichet, head of the European Central Bank, told bankers at a dinner to celebrate his achievements that regulators should 'give the first refusal to the market meditation' in responding to the crisis. Hank Paulson, US Treasury Secretary, emphasized the need for further analysis of the crisis before deciding if any regulatory steps were needed, while Callum McCarthy, chairman of the FSA, warned his fellow regulators that they must avoid 'mad dog responses' to the crisis.[99]

As well as holding private functions with supervisors, the IIF sought to gain early leverage by pre-empting regulatory action in response to the crisis. At the same time as it met with supervisors in Washington, the institute created a private-sector committee under its auspices to look at five key aspects of the credit crisis.[100] In place of government action, the new committee would produce a set of industry best practices by spring 2008. The IIF also produced a lengthy report in April 2008 detailing the failings of the banking industry in the run-up to the crisis – an attempt, Chairman Josef Ackermann admitted, 'to do our utmost to clean our houses first and not leave it to the regulators to do that for us'.[101] Once again, the IIF was adamant that steps taken to prevent a repeat of the crisis should be implemented through voluntary codes of conduct, and warned that 'premature regulatory measures' would damage a formerly thriving sector of the economy.[102] The IIF was soon joined by some familiar faces. In February 2008, the ASF voiced its own fears about a regulatory crackdown on the securitization industry following heavy losses on mortgage-backed securities, and soon after launched its own initiative aimed at restoring confidence in the industry ('Project RESTART'), the centerpiece of which was a set of reporting best practices for originating banks.[103] In September, meanwhile, the ISDA warned American regulators that any attempt to regulate the controversial credit derivatives market with 'ill-fitting regulatory regimes' would 'deter healthy economic activity'.[104] Problems emerging during the crisis, the association insisted, could be fixed by voluntary industry action.

So far, these groups have enjoyed a great deal of success in forestalling higher capital requirements in the aftermath of the crisis. As the first to contribute to the post-crisis regulatory discourse, they have managed both to neutralize the political pressure on supervisors and to ensure that early promises for more stringent regulation have not been fulfilled. When G-7 finance ministers met in Washington in October 2007, they pledged a package of 'fundamental reforms' of the financial system by spring 2008. When they met again, however, in Tokyo in February 2008, the ministers had completely changed their tune. There was a strong desire among them, one observer noted, to avoid an 'overreaction' to the crisis.[105] One senior official even suggested that although ministers might 'bang the drum' of tougher regulation, they would be careful to avoid heavy-handed responses to the crisis.[106] Private meetings between banking executives and regulators continued throughout 2008 and into 2009 – not, it hardly needs to be said, the most open or representative forum in which to devise new rules for the global financial system. There was particularly close cooperation between the two in the run-up to the G-20's April 2009 London Declaration. As representatives from major banks descended on Basel for a conference with supervisors hosted by the BIS, one executive revealingly claimed that it was 'important to be at the negotiating table well before decisions are made. We need to make our

voice heard'.[107] It is perhaps no surprise that, in the end, the London Declaration stipulated that 'until recovery is assured, the international standard for the minimum level of capital should remain unchanged'.[108] The latest round of G-20 talks, the September 2009 Pittsburgh summit, has unfortunately brought no more progress. While reiterating the familiar pledges to 'raise capital standards' and 'discourage excessive leverage', the Leaders' Statement failed to offer any guidance about how these might be put into practice.[109] As one central banker warned: 'The Achilles heel of this process is the calibration that is missing at the moment – both on the liquidity side and on the capital side.'[110]

For domestic initiatives to raise capital requirements, the story is much the same. In the UK, despite promising a 'revolution' in the way banks are regulated, the FSA failed to make any specific recommendations about the amount of capital banks should hold in its much anticipated 'Turner Review'.[111] The City of London's reaction to the report, as one commentator put it, was one of 'relief' at the 'lack of surprises' within it.[112] Similarly, after assuring the public that banks would be 'brought back down to earth', the Treasury's July 2009 white paper on financial reform left 'the details [of capital regulation] to be worked out later'.[113] One banking executive described the paper – with more than a hint of gladness – as 'just a deferral of any decisions until after a general election'.[114] In the US, meanwhile, the Treasury Department's June 2009 financial white paper echoed Timothy Geithner's call in March for more 'robust capital requirements', but as a former banker at the Brookings Institution commented, 'The fact that the details were not spelt out will give the big institutions scope to water it down'.[115]

What about the Basel Committee? Shortly after the crisis broke out, Chairman Nout Wellink admitted that serious changes to Basel II were needed, including a major 'strengthening of the capital framework' in pillar 1.[116] Predictably, though, progress has been incremental. While the Committee has moved swiftly in specific areas of the trading book, increasing the market risk capital charge and reducing the incentives for 're-securitization', fundamental reform of Basel II has yet to take place.[117] The most dangerous aspects of the accord – the excessive reliance on banks' internal ratings and proprietary models – have remained very much intact. This has not gone unnoticed. A recent report by the Government Accountability Office, a Washington-based think tank working for the US Congress, took regulators to task for failing to enact more 'fundamental changes under a new Basel regime'.[118] This is particularly important, the report suggests, since 'the crisis highlighted past concerns about the approach to be taken under [the A-IRB approach]…such as the ability of banks' models to adequate measure risks for regulatory capital purposes'.[119] Given the Committee's close links to the banking industry, however, its preference for the regulatory status quo is not surprising. Not only were banking lobbies amongst the few organizations to comment on the Committee's latest proposals, but one of the most vocal critics of a 'knee-jerk reaction' to the crisis, the IIF and Merrill Lynch's Marc Saidenberg, is now a member of the Committee itself.

In sum, the neo-proceduralist framework outlined earlier offers a disturbingly pessimistic assessment of the prospects of post-crisis initiatives to raise global requirements – the prospects, that is, of a 'Basel III'. By pre-empting supervisory action and conducting private meetings with regulators while the dust was still settling on the crisis, powerful banking lobbies have already foreclosed – and will continue to foreclose – any possibilities of an effective regulatory response to the crisis. As the framework suggests, both key information about new initiatives, mainly

through personal contacts with regulators, and the exclusive setting in which these initiatives are debated will be critical to the success of industry groups. From the G-20 to FSA to the Basel Committee, the fate of post-crisis efforts to reform capital regulation may turn out to be a case of history repeating itself.

Conclusion

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

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

Unfortunately, as we have seen, these very same factors may have also jeopardized more recent efforts to raise international capital requirements in the form of 'Basel III'. Given the importance of reform in this area for the health of the global economy, it is crucial therefore that we heed the lessons of the neo-proceduralist analysis. Future efforts to revise capital adequacy standards must both observe basic standards of due process and ensure that information asymmetries are as small as possible – principally, but not exclusively, by maintaining some kind of distance between supervisory bodies and the banking industry. Though difficult in practice to achieve, if implemented faithfully, these changes would go a long way towards ensuring that the next time regulators set out to revise international capital standards, they achieve every one of their aims.

[1] *Reuters*, 22 October 2007.
[2] I provide evidence for this claim in Section IV.
[3] Mattli and Woods 2009, 10.
[4] Cohen 1986.
[5] Tarullo 2008, 16.
[6] In March 2009 the Basel Committee decided to expand its membership to include all G-20 countries.
[7] Wood 2005, 41; Tarullo 2008, 2.
[8] Author's interview with former BCBS member, Oxford, October 2008.
[9] BCBS 1988.
[10] *Financial Times*, 22 September 1997, 4.
[11] Jackson et al 1999.
[12] A July 1998 survey found that the average Tier 1 capital of the largest 1,000 banks made up only 4.48% of total assets, its lowest level since 1992. Cited in Wood 2005, 124.
[13] BCBS 1999.
[14] *Financial Times*, 28 June 2004, 24.
[15] The different aspects of credit risk include probability of default, expected loss given default, and exposure at default. Estimates of these are fed into a formula which determines the amount of capital that should be held against a given exposure.
[16] BCBS 2004a. The market risk charge was incorporated into Basel I in the 1996 Market Risk Amendment. See BCBS 1996.
[17] OCC, FRS, FDIC, and OTS 2006.
[18] FDIC 2003.
[19] BCBS 2006.
[20] *Financial Times*, 10 April 2006, 23.
[21] BCBS 2006. For some banks the drop was as much as 43%.
[22] BCBS 2004a, 2, 4.
[23] Wood 2005, 2.
[24] Ibid, 163.
[25] See the House Financial Services Committee's comments to US regulators in 2003. *Financial Times*, 03 December 2003, 1.
[26] Bjerke 2007.
[27] The Committee first expressed an interest in updating Basel I in response to a report published by international bankers in November 1997. *Financial Times*, 19 November 1997, 20.
[28] Griffith-Jones and Persaud 2003.
[29] Ibid. 2003, 2.
[30] Mattli and Woods 2009.
[31] See Kingsbury, Krisch, and Stewart 2004.
[32] Mattli and Woods 2009, 13.
[33] See Pierson 2004.
[34] Ibid, 71.
[35] Calculated with data from the FDIC's 2008 Summary of Deposits, available at <http://www2.fdic.gov/sod/index.asp>. Accessed 14 August 2009. The five banks are Bank of America, JPMorganChase, Wells Fargo, Citigroup, and State Street.
[36] Putnam 1988, 436.
[37] George and Bennett 2005, 6.
[38] See the Global Accountability Report (Blagescu and Lloyd 2006). The BIS has one of the lowest scores on its index of transparency (28%), participation (11%), and complaint and response mechanisms (33%).
[39] Author's interview with former BCBS member, London, December 2008.
[40] Author's interview with, former BCBS member, London, December 2008. The four subgroups are the Accord Implementation Group, the Policy Development Group, the Accounting Task Force, and the International Liaison Group.
[41] Information available at < http://www.bis.org/bcbs/index.htm.>. Accessed 14 August 2009.
[42] Davies and Green 2008.
[43] Author's interview with former BCBS member, Oxford, December 2008.
[44] Author's interview with former BCBS member, Oxford, October 2008. The IIF was founded in 1983.

[45] Author's interview with former BCBS member, New York, January 2009.
[46] IIF 2001a. The most frequent meetings with banking executives appear to have been conducted by the Federal Reserve trio of William McDonough, Roger Ferguson, and Darryll Hendricks – all of whom had a private-sector background and went on to work at major banks after leaving the Basel Committee. Author's interview with former BCBS member, Washington D.C. January 2009.
[47] See IIF 1997.
[48] Jackson, Nickel, and Perraudin 1999, 100.
[49] Treacy and Carey 1998.
[50] BCBS 1999, 37.
[51] *Financial Times*, 13 April 2000, 13.
[52] Ibid.
[53] Author's interview with former BCBS member, Washington D.C., January 2009.
[54] Available at <http://www.bis.org/bcbs/ca/iistctonreca.pdf>. Accessed 15 October 2008.
[55] Author's interview with Vice President of community bank association, Washington D.C., January 2009.
[56] Available at < http://www.bis.org/bcbs/ca/midindbk.pdf>. Accessed 15 October 2008. P.1, para 4.
[57] Available at < http://www.bis.org/bcbs/ca/amcobare.pdf>. Accessed 15 October 2008. P.2, para 2.
[58] Ibid, p.2, para 3.
[59] Available at < http://www.bis.org/bcbs/ca/rebkofin.pdf>. Accessed 15 October 2008. P.2, para 2.
[60] Available at <http://www.bis.org/bcbs/ca/pebkofch.pdf>. Accessed 15 October 2008. P.2, para 2.
[61] Available at < http://www.bis.org/bcbs/ca/thbacosoaf.pdf>. Accessed 15 October 15 2008. Article 2.12, para 6.
[62] Author's interview with former BCBS representative, Washington D.C. January 2009.
[63] *Financial Times Online*, 25 September 2001.
[64] Ibid.
[65] Available at <http://www.bis.org/bcbs/ca/isdaresp.pdf>. Accessed 15 October 2008. Article 6, para 1.
[66] Author's interview with former BCBS member, Washington D.C., January 2009.
[67] *Financial Times*, 18 February 2004, 22.
[68] Ibid.
[69] BCBS 1993.
[70] IIF 1993.
[71] *Financial Times*, 7 September 1994, 21.
[72] BCBS 1995.
[73] Ibid, 5.
[74] *Financial Times*, 12 April 1995, 19.
[75] *Financial Times*, 29 January 1999, 3.
[76] IMF 1998.
[77] Author's interview with former BCBS member, London, December 2008.
[78] Available at <http://www.bis.org/bcbs/ca/eursecfor2.pdf>. Accessed 15 October 2008. P.4, article 1, para 1.
[79] BCBS 1999.
[80] BCBS 2001, 13.
[81] BCBS 2004b.
[82] *Risk*, March 2004.
[83] Available at < http://www.bis.org/bcbs/ca/eursecfor2.pdf>. Accessed 15 October 2008.
[84]Available at <http://www.bis.org/bcbs/ca/iiwgoncaad.pdf 11>. Accessed 15 October 2008. P.11, article 10; BCBS 2001.
[85] Blundell-Wignall and Atkinson, 79.
[86] OCC, FRS, FDIC, and OTS 2006.
[87] Blundell-Wignall and Atkinson 2008, 58.
[88] Ibid.
[89] Ibid, 79.
[90] Ibid, 60.
[91] Ibid, 88.
[92] *Financial Times*, 02 June 2008, 7.
[93] FSA 2009.
[94] *Reuters*, 2 March 2009 ; *Financial Times*, 27 March 2009, 11.
[95] Available at < http://www.g20.org/Documents/g20 _summit_declaration.pdf.>. Accessed 14 August 2009.

[96] *Financial Times*, 18 June 2009, 2.
[97] *Financial Times*, 22 October 2007, 4.
[98] Ibid.
[99] Ibid.
[100] *Financial Times*, 22 October 2007, 10.
[101] IIF 2008; *Financial Times*, 10 April 2008, 2.
[102] Ibid.
[103] Available at <http://www.americansecuritization.com/restart>. Accessed 14 August 2009.
[104] *Financial Times*, 01 October 2008, 11.
[105] *Financial Times*, 09 February 2008, 2.
[106] Ibid.
[107] *Financial Times*, 10 January 2009, 5.
[108] Available at <http://www.londonsummit.gov.uk/en/summit-aims/summit-communique>. Accessed 14 August 2009.
[109] Available at <http://www.pittsburghsummit.gov/mediacenter/129639.htm>. Accessed 30 September 2009.
[110] *Financial Times*, 26 September 2009, 3.
[111] FSA 2009.
[112] *Financial Times*, 19 March 2009, 2.
[113] *Wall Street Journal Europe*, 10 July 2009, 12.
[114] *Financial Times*, 09 July 2009, 1.
[115] US Treasury 2009; *Financial Times*, 18 June 2009, 7.
[116] Available at <http://www.bis.org/press/p071009.htm>. Accessed 14 August 2009.
[117] BCBS 2009.
[118] GAO 2009, 72.
[119] Ibid, 6.

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