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Banking on the public: market competition and shifting patterns of governance

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Chapter 4

Bank capital adequacy under the Basel Capital Accords

In this chapter the international policymaking process concerning bank capital adequacy standards since the 1980s is studied and related to the developments in the market structure of the banking sector. In doing so, this case study sheds light on the relationship between the market structure in the banking sector and the patterns of governance of bank capital adequacy. Banking has always been prone to periodic crises, the socio-economic costs of which have been significant. The average banking crises in the post-Bretton Woods period lasted for 2.6 years and led to a cumulative loss of GDP of 6.2 per cent.¹ The current crisis has seen the collapse of some high-profile banks (most notoriously Lehman Brothers) and required billions in state support and nationalisations to prop up many others. This has subsequently led to severe fiscal consolidation (budget cuts) in many states, having an impact on a wide range of public services and welfare arrangements. The governance of bank capital adequacy seeks to reduce these costs by ensuring the safety and soundness of the banking sector, but also has an important impact on the terms of competition for banks and the cost of credit in an economy.

The analysis in this chapter starts with the negotiations on the first Basel Capital Accord (Basel I) which were finalised in 1988 and traces the process onwards to the major overhaul that led to the second Basel Capital Accord (Basel II, agreed on in 2004). The development in this policy domain in the aftermath of the current crisis will be dealt with in the concluding chapter. Five core arguments will be made in this chapter.

First, it will be argued that the governance pattern for bank capital adequacy emerging in the late 1980s (reflected in the Basel I Capital Accord) can be characterised as an international level, public pattern of governance that was relatively stringent for banks. Basel I in the first instance applied to the members of the BCBS (which largely overlap with the members of the G10). The first dimension of this governance pattern could be categorised as 'international', not applying to all countries globally and also not to a specific region (in geographical terms). On the 'nature' dimension, Basel I is public, being implemented by public bank supervisors with limited room for (private) bankers' input. Basel I was stringent in the sense that it set a fixed 8 per cent capital charge against risk-weighted capital. This risk-weighted capital was calculated through five risk categories, hence constraining banks' flexibility in addressing

risks in their balance sheets through economic capital.

Second, it will be argued that the policymaking process leading to this pattern of governance was centred on US public authorities with the BCBS in an auxiliary role. The preferences of US authorities were heavily shaped by the fact that the Latin American debt crisis had brought their banking system to the brink of bankruptcy and necessitated significant official refinancing of debtor countries to be saved (see also the next chapter on the Latin American debt crisis). Domestic political dynamics led to a push for more stringent regulation (increasing bank capital), while banks saw this as an opportunity for international harmonisation (and consequently not only levelling, but also virtually opening up the playing field). These preferences came together in policymaking 'institutions' dominated by the US (initially in the form of bilateral and later trilateral negotiations). Only late in the process did the negotiations move to the BCBS in earnest. Given this process, it should come as no surprise that US preferences with respect to the governance pattern largely prevailed. The yardstick in the policymaking process had been defined early on as ensuring the safety and soundness of banks *and* levelling the competitive playing field.

The third argument concerns the relation of the shifts in governance of Basel I to the terms of competition and market structure in banking. It will be argued that first of all the international harmonisation of capital adequacy standards that Basel I entailed promoted further internationalisation of the banking sector. It furthermore encouraged consolidation of the banking sector. As a consequence the inter-firm terms of competition changed in the sense that international players entered domestic markets (there was international market integration) and more direct competition now took place between larger institutions. Most importantly, banks gained an incentive to change their business model from 'traditional' relationship banking to more capital market-based activities that would not show up on the balance sheet (and hence not bear a capital charge). Banks developed complex risk management models to gain a competitive edge in this new market structure, for example based on Value-at-Risk (VaR) models. This significant change in market structure led to new challenges to maintain capital adequacy (also due to the 'gaming of the system' by banks).

This leads to a fourth argument: this change in market structure led to an adjustment of the preferences of both internationally active private banks and public supervisory authorities regarding the governance pattern. This culminated in the renegotiation of Basel I. The policymaking process for this renegotiation was concentrated in the Basel Committee as the main policymaking institution. While this gave the negotiations a more multilateral character, it also provided a fruitful lobbying avenue for representatives of the international banking community (most notably the IIF). The skewed argument pool this implied quickly led to a focus on 'market-based' approaches (i.e. based on internal models).

Looking at the first dimension of governance, the Basel II Accord represented a shift upward on the jurisdictional dimension. Already during the 1990s, Basel I had become adopted by more and more countries outside of the original G10 countries. Basel II formalised this shift

¹ Bordo et al, 2001, table 1 (p. 59). Based on a 56 country sample over the period 1973 – 1997.

upward by explicitly aiming for global implementation, for example reflected in the establishment of an Accord Implementation Group. On the second ‘nature of governance’ dimension, it will be argued that a shift took place towards a more private form of governance. Where Basel I set crude risk categories in determining risk-weighted capital, Basel II led specific groups of private actors to determine their risk-weighted capital through their own risk models. An important part of supervision was, as it were, handed over to private actors. The proposals for the use of internal risk models imply a shift to less stringent governance, as banks would have more leeway in conducting their business through the use of their own internal risk models. Consequently, a shift in the third dimension (for a specific group of banks) can be observed.

Fifth and finally, it is argued that the focus on market-based instruments like the Internal Ratings Based (IRB) approach can be explained by the relatively strong position of internationally active banks within the relevant policymaking institutions, and by an argument pool skewed towards market-based solutions among the participants in the policy community. Participants in the policy community were reluctant to bring up hesitations about the model-based approach. On the other hand, public sector preferences are reflected in the comprehensiveness of Basel II, e.g. by including operational risk despite fierce opposition of the private sector.

In developing these arguments, this chapter makes two main contributions to the overall objectives of the thesis, as well as to the existing literature (see also the discussion of the literature in the next section). First of all, by including the developments in market structures in the analysis, it becomes clear how governance and market structures are interlocked through the policymaking process. The internationalisation of the banking sector leads to private sector calls for international harmonisation, while official sector representatives seek to address the implications of international operations on financial system risk. This struggle is reflected in the policymaking process of both Basel I and II. Through the analysis presented in this chapter, a simultaneous explanation of the developments in market structure and shifts in governance pattern is provided. This is one of the main contributions to the existing literature, and to the overarching argument of this thesis.

A second contribution builds on the first: by showing the relationship between market structure and governance pattern – by means of the feedback loop from shifting patterns of governance (Basel I and II) to changing market structures in the form of capital market activities of banks – it becomes clear how public and private actors interact in a globalised market system. This aids our understanding of the changing power configurations between public and private actors in a time of financialisation.

This chapter is set up as follows. In the first section, the literature on the Basel process is discussed. This shows the nature of the contribution of this chapter’s analysis. The negotiations on the first Basel Accord are discussed in the second section. This is followed by an analysis of the impact of Basel I on the market structure in the banking sector in section three. This section also works towards an explanation of the start of the negotiations on Basel II, which will be discussed in section four. The final section concludes with an analysis of the

developments and some preliminary implications of this case for the argument set out in this thesis.

Analysing the governance of bank capital adequacy

The issue of banking regulation has been a fruitful avenue for IPE research from a variety of perspectives (as well as from adjacent disciplines such as Economics and Law). The literature discussion below starts with early accounts of the BCBS and the policymaking process on Basel I, followed by a discussion of the literature on the Basel II negotiations. Wood (2005) and Tarullo (2008) are contributions that cover both policymaking processes extensively and consequently cover the same ground as this chapter.

Reinicke (1995) provides an account of the Basel process as a sideline to his central story of the regulation of American commercial banks. He paints a vivid picture of the origins of the American push for international harmonisation of regulation in US domestic politics. However, the explanation for the emergence of Basel I in the international negotiations is less clear (perhaps unsurprisingly for a US-focused study). Reinicke points to the emerging consensus among central bankers on the issue of bank capital adequacy standards, which was formed in discussions from the late 1970s onwards. This consensus was a response to safety and soundness concerns, and could consequently be described as a functionalist response to market developments. It remains unclear, however, how he explains that the BCBS finalised the Basel Accord in the face of national divergence on capital adequacy standards.² He furthermore points to the increasing lobby of domestic banking constituencies to their banking supervisors for adjustments to the Accords in favour of national idiosyncrasies.³ His account remains state-based, however, and is especially focused on the US.

Norton (1995) describes how the American push for a capital accord linked up in the BCBS with efforts in the European Union to harmonise capital requirements in the context of the European Union’s common market project. In his account, this provided the rationale for reaching the Basel I Accord, while the US-UK agreement on capital adequacy standards served as an ‘intervening catalyst’. Besides the fact that this seemingly underestimates the crucial importance of the US-UK agreement, a drawback of his study is that he fails to take into account market developments or the role of private actors in the policymaking process. Coming from the law discipline, the focus of his contribution understandably lies with the regulators.

In a number of contributions, Kapstein has provided a largely functionalist account of the emergence of the Basel process and Basel I.⁴ Market failures that emerged with the interna-

² Regulatory arbitrage seems to play a role in his account, Reinicke, 1995, p. 165.

³ Reinicke, 1995, p. 164.

⁴ Kapstein, 1989, 1992 and 1994.

tionalisation of banking led to a need for international cooperation. Supervisors responded to this by developing the Basel Accord. Kapstein provides an intergovernmental account (which he admittedly sets out to do) and pays relatively little attention to the political context in which policymaking takes place and to the different interests within the banking sector and between supervisors. His account does not elaborate how the preferences for certain governance patterns of both public and private actors are shaped by the international integration of the market.

Oatley & Nabors (1998) respond to a number of the drawbacks of Kapstein's functionalist account. They provide an interest-based explanation for the emergence of Basel I, focused specifically on the interests of the American banking sector and exercise of American power (through the threat of exclusion from the US market) in pushing the Accord. What this account underemphasises, however, is the impact of the internationalisation of the banking market on the governance pattern – a drawback shared with Kapstein's account. Although the US policymaking process certainly was crucial for the development of the Accord, the international negotiations were not simply a deferral to US preferences.⁵

A bridge between analyses of Basel I and II is provided by Singer (2007). He aims to explain regulators' preferences for global financial regulation, and uses capital adequacy regulation as one of his 'successful' cases. He explains the outcome of the international negotiations on the Capital Accords as the result of a balancing act between stability and international competitiveness.⁶ However, this analysis gives limited attention to the emergence of international actors in the policymaking process concerning Basel II. As he seeks to explain regulators' preferences, it is also a state-oriented analysis.

Claessens, Underhill & Zhang (2008) argue that the policymaking process leading to Basel II can be explained by an exclusionary policymaking community with substantial private sector influence.⁷ The developments were thus to a large extent determined by a congruence of specific preferences and a specific policymaking institution. This led to an Accord that accommodated internationally active banks, while potentially having the effect of hampering other types of banks and developing country borrowing. In a similar vein, Tsingou (2008) points to the importance of the G30 and IIF as respectively hybrid and private actors in the policymaking process.

Kette (2009) focuses on the ideational factor in his explanation of the Basel II negotiations. According to Kette, the paradigm shift represented by Basel II is a shift from quantitative rule-making towards a model of supervision based on dialogue (as in the second pillar of Basel II). In the terminology of this thesis this would be called a shift towards less stringent

governance and likely also a shift in the nature of governance towards more mixed public-private governance (from public governance). Importantly, he claims these shifts in governance came about through a policymaking process that was also focused on dialogue and learning. Through their interaction with stakeholders, supervisors learned the 'better way' of setting capital adequacy standards in the form of Basel II. This learning was necessary due to the complexity of modern financial systems and the information asymmetry between private financial firms and supervisors. Kette gives scant attention to the skewed nature of this 'learning' and the politics of the negotiations, however. In light of the current crisis, whether Basel II is the 'better way' of setting capital adequacy standards can be seriously doubted.

An analysis from a critical IPE viewpoint is offered by Bieling & Jäger (2009). They see Basel II as the result of demands from large international banks for more market-based regulation. Their focus is on the EU, where the European stance in favour of more market-based forms of banking supervision is a result of a coalition of transnational financial corporations and neoliberal European institutions. This coalition saw the negotiations in the BCBS as an opportunity to promote the transition to an Anglo-Saxon style of capitalism.⁸ Although they do acknowledge accommodation in the policymaking process of, for example, SME concerns, they emphasise that the thrust of the accord is driven by transnational financial forces and focus on the impact this has on the socio-economic structures in the real economy of the EU.

Coming to the analyses that span both the Basel I and II negotiations, Wood (2005) provides an excellent discussion of the negotiations in the BCBS. His account follows Oatley & Nabors in pointing to the influence of American banks in internationalising domestic standards and levelling the playing field, as well as to the threats by the US and US-UK of exclusion from their market that were necessary to push through the final Accord. With respect to the negotiations on Basel II, Wood points to the private sector pressure that was crucial in starting the negotiations. He continues to discuss a number of disputes between the members of the G10 that were pivotal in shaping the Accord. In both policymaking processes, conflicts and power politics of the members of the G10 are consequently essential in the explanation of the outcome. Although he does give attention to the role of private actors, the thrust of his analysis is state-based, as he aims to expose the politics underpinning the supposedly technocratic intergovernmental negotiations.

An insightful and policy-oriented account of the BCBS negotiations on the Capital Accords is provided by Tarullo (2008).⁹ He concludes (narrowly framed) "that Basel II's detailed rules for capital regulation are not an appropriate basis for an international arrangement among banking supervisors"¹⁰ and criticises the influence of commercial and bureaucratic interests on the Basel II negotiations. He mostly provides a descriptive account, but does show how the BCBS' members were drawn into designing the optimal bank regulatory regime from a theoretical

⁸ Bieling & Jäger, 2009, p. 88.

⁹ Tarullo is currently serving as a member of the Board of Governors of the Federal Reserve.

¹⁰ Tarullo, 2008, p. 5.

⁵ See e.g. Chey, 2006 for an analysis of the role of Japanese public and private actors in the negotiations. Off-the-record interview sources from the 1990s furthermore contradict Oatley & Nabors' account of US success in pushing regulatory costs on competitors.

⁶ Singer, 2007, p. 66.

⁷ See also Claessens & Underhill, 2010.

perspective under the umbrella of the IRB in a process resembling groupthink (which led to the exclusion of other options). This process was largely driven by the Federal Reserve and the private sector in Tarullo's (somewhat US-centric) account. This set the yardstick for the outcome of the policymaking process, with regulators stumbling along in the process without fully knowing which problems they would face in designing a solution which would measure against this yardstick.

Although much of this literature provides a base to build upon, a contribution can be made by extending the analyses to both market structure and governance pattern. Many of the aforementioned studies are state-based, and do not give adequate attention to private actors and developments in the banking market. The analysis provided here will overcome this dichotomy and show how public and private actors operated in a state-market condominium. Taking the developments in the policymaking process and in the terms of competition into account will allow for a better understanding as to why certain preferences for renegotiation of Basel I emerged and how these interacted with policymaking institutions and group processes to lead to Basel II.

Obviously, another contribution of this chapter lies in extending the analysis from the Basel I process to the Basel II process, or vice versa by providing the historical background to the Basel II process in an integrated analytical framework. This shows how the feedback loop between market structure and governance pattern operates and hence provides a richer explanation of the developments than by focusing on one single episode. In the following section, the first stage of these negotiations will be analysed: the negotiations leading to Basel I.

The onset: preliminary international coordination and confrontation resulting in Basel I

In the previous chapter, it was already noted that with the internationalisation of banking, capital adequacy ratios had declined and the capacity of national supervisors to successfully implement domestic standards was diminished. This had led to tentative discussions among supervisors on capital adequacy in light of the dangers to the safety and soundness of banks these developments entailed. Although in most cases the increasing interest in capital adequacy did not result in formal capital requirements, bank supervisors asked banks to provide them with information on their capital adequacy ratios.¹¹ These tentative discussions among bank supervisors received an important impetus from the Latin American debt crisis. This put the spotlight on the internationalisation of the banking sector and the broad decline in capital adequacy. Supervisors noted that the potentially disastrous effects of the Latin American debt crisis on the banking sector was not because of circumvention of supervision,

¹¹ Tarullo, 2008, p. 40-41.

but because the current governance pattern did not prevent these new risks from being taken with adequate insurance against potential hazardous consequences.¹² The new international banking environment apparently posed more challenges than the Basel Concordat was able to counter.

In addressing the Latin American debt crisis, it was also underscored how different approaches taken by supervisors could affect international competition in the global banking market. Notably, Japan chose to shoulder the burden of the bad debts of the domestic financial sector by changing the tax code to allow for the deduction of a portion of the loan losses.¹³ This further enhanced fear of the international competitive power of Japanese banks, which was already riding high at the time.

The American approach to the crisis, on the other hand, implicitly meant promoting IMF funding of the debt-laden emerging markets to ensure American banks loans were eventually repaid.¹⁴ In the US, especially in Congress there was a lot of resistance against this US approach of 'bailing out' money centre banks, however. The required capital increase for the IMF (of which the increase of the American quota would have to be approved by Congress) provided the opportunity to voice this resistance. Reinicke quotes the chairman of the House Banking Committee in 1982 commenting: "At a time when millions stand in unemployment lines and thousands of small businesses are filing bankruptcy petitions, the idea of an international bailout for adventurous U.S. bankers may not be the most popular item on the legislative agenda."¹⁵ However, House and Senate realised that not agreeing to the IMF quota increase could lead to further economic turmoil, which would hurt American exports. Therefore a deal was made where large-scale official refinancing of the debtor countries would be enabled through an IMF quota increase, while at the same time the American banking sector would face stiffer regulation to avoid political backlash in domestic constituencies.

American regulators were divided on the issue of stricter regulation, with especially the Fed backpedalling. Federal Reserve Chairman Paul Volcker seemed closely aligned with private sector preferences by warning against excessive regulation and pointing to the deterioration in the international competitive position of US banks additional capital charges would cause.¹⁶ In an attempt to pre-empt legislative intervention, the US banking supervisors produced a rather bland five point plan, which called for further analysis of capital adequacy in relation to (international) portfolio diversification and greater transparency. It did not include formal capital adequacy standards, however.¹⁷

The US banking sector resisted the push from Congress even more forcefully, with the vice chairman of Chase Manhattan Bank stating "a tighter web of administrative controls

¹² Wood, 2005, p. 68.

¹³ Kapstein, 1994, p. 103.

¹⁴ See also the next chapter for a more elaborated analysis of the 1980s debt crisis.

¹⁵ Chairman St. Germain, 21 December 1982 quoted in Reinicke, 1995.

¹⁶ See also Wood, 2005, p. 71-72 on the close association of Volcker with US bankers' preferences.

¹⁷ Reinicke, 1995, p. 144.

around the foreign lending of banks, as some have suggested, would be unwise, unnecessary and counterproductive (...) Frankly, I don't really feel that we need a whole lot of new regulation to solve this problem."¹⁸ Private sector representatives even rejected the modest five point plan of the US regulators, to the dismay of members of Congress.¹⁹

When bankers successfully challenged the authority of American regulators to set capital adequacy levels under contemporary legislation, the balance in Congress was tipped in favour of strict capital adequacy regulation.²⁰ The appearance of a bailout had to be avoided, which resulted in the 1983 International Lending Supervisory Act (ILSA) setting a capital adequacy standard for all US banks. The ILSA implied a domestically implemented supervisory regime for banks that would have imposed additional costs on the banking sector relative to its foreign competitors. Domestic concerns about the impact on the competitive position were alleviated by giving the Fed a mandate to seek international agreement on minimum capital adequacy standards.²¹

The initial impulse for a shift in the governance of bank capital adequacy to the global level was thus due to the interaction in the domestic US policy community between Congress, supervisors and banks. The changes in the market structure of banking that had occurred during the 1970s were responsible for this impulse in two ways. First and foremost, the internationalisation of bank lending to emerging markets had led to a global financial crisis. Western banks were brought to the brink of systemic failure, increasing the urgency for public actors to find a governance pattern that would ensure the safety and soundness of banks. Secondly, the internationalisation had led to a global – but as yet uneven – competitive playing field. On this global playing field, differences in domestic standards for bank supervision, as well as the processes used to ensure safety and soundness could lead to competitive (dis)advantages over banks in other countries. Furthermore, banks had an interest in ensuring the safety and soundness of their counterparts.²² These forces combined to give (especially US) supervisors a preference for strengthening the international supervisory framework (pressured by public opinion), while the banks had a preference for encouraging international convergence of supervisory frameworks. This resulted in a dual focus on the 'safety and soundness of banks' and 'levelling the international competitive playing field.'

After adopting the ILSA, the US Congress mostly lost interest in the further process of bank capital adequacy standards.²³ It was now up to the Fed to propose negotiations on an international agreement on capital adequacy standards in the BCBS as a result of the domestic

compromise. Initially this was not very enthusiastically received by most other members of the BCBS. When Volcker laid out his plans in the BCBS in March 1984, they were "greeted with a yawn," as Kapstein quotes an insider.²⁴

Although some BCBS supervisors were already working with the concept of risk-weighted capital adequacy standards, each had their own views on the necessity of formal, internationally coordinated capital standards. When the BCBS had initially worked on this issue (as mentioned in chapter three), it had resulted in an appeasement of all members: a definition of bank capital consisting of six tiers and risk-weighting of assets consisting of seven categories (in addition to the use of a gearing ratio).²⁵ This meant international harmonisation without adjusting national diversity in regulations, and the 'yawn' in response to Volcker was likely the result of this experience. Besides, the European Community had already embarked on their own supranational regulatory project (notably with a similar dual focus on soundness and competitiveness). The BCBS was thus reluctant to function as a policymaking institution whereas the US plans for international harmonisation could benefit from further development.

However, the Bank of England (BoE) was less sceptical towards US overtures than most BCBS members and willing to negotiate a bilateral agreement. They supervised the European financial capital with the largest presence of American banks, and more important had already moved to a risk-weighted standard (the American system was inspired by the UK one).²⁶ Hesitations about the development of harmonised regulation in the EU might also have played a role.²⁷ The private sector in both countries encouraged the creation of a bilateral deal, being aware of the competitive inequalities caused by different supervisory standards.²⁸ The negotiation of a bilateral accord would lead to a pattern of governance at the 'bilateral' level, comprising the two single largest global financial centres. Over the course of 1986, the US and UK silently engaged in negotiations.

Since both the US and the UK were already working with quite similar capital adequacy standards, they managed to reach an agreement fairly quickly, completing it in January 1987. One of the main steps forward in these negotiations was on the topic of the definition of capital, which would return in later negotiations. The bilateral US-UK agreement incorporated a risk-weighted approach, but had a simple two-tier capital structure. The latter meant a distinction between base primary capital (stocks, retained earnings, general reserves and some other items) and a second tier of limited primary capital including, for example, some types of subordinated debt. The second tier of capital could not exceed half of total base capital in counting towards the capital adequacy ratio.

²⁴ Interview quote in Kapstein, 1994, p. 108.

²⁵ Norton, 1995, p. 184 – 185.

²⁶ Wood, 2005, p. 75-76.

²⁷ Kapstein, 1992.

²⁸ Reinicke, 1995, p. 168.

¹⁸ Quoted in Reinicke, 1995, p. 145.

¹⁹ Reinicke, 1995, p. 145.

²⁰ Reinicke, 1995, p. 146-147. The fact that large money centre banks had in the meantime already improved their capital ratios was also likely a contributing factor.

²¹ Oatley & Nabors, 1998.

²² Off-the-record interview.

²³ In an off-the-record interview with a public actor 1992, it was mentioned Congress was not much involved in the negotiations.

The US-UK agreement served as a strong incentive for other members of the G10 to overcome their initial reluctance and come to a substantive multilateral agreement.²⁹ There was the not-always-subtle threat emanating from the US-UK agreement of closure of the world's two foremost financial centres to banks under diverging supervisory standards. If the other G10 members were to be able to influence the final Accord (e.g. regarding national exceptions and competitive interests) they needed to get involved.³⁰ The BCBS consequently decided in January 1987 to negotiate an Accord, for which the US-UK agreement provided a strong foundation.³¹

The first focal point for the US and the UK, however, was the third financial superpower: Japan. At the time, Japanese banks were seen as a major competitive threat to the Western world, and part of their competitive advantage was thought to be beneficial supervisory arrangements. During the early 1980s, the Japanese recognised that an overly large deviation from the trend in other G10 countries could lead to friction with other countries, and they had already started designing their own capital standards.³² To imitate the other countries' standards without actually raising capital standards for Japanese banks, banks were allowed to count 70 per cent of unrealised stock market gains as capital.³³

The US-UK agreement encouraged the Japanese supervisors to continue working on a capital standard, especially when the threat of exclusion seemed to materialise. The banking licenses for several Japanese banks wanting to enter the US market were postponed, supported by several policy statements by US and British policymakers aimed at getting the Japanese supervisors to fall in line with the Anglo-Saxon discussion. This brought Japan to the negotiating table even though the Ministry of Finance of Japan did not believe higher capital levels were necessary for Japanese banks.³⁴

In the subsequent trilateral negotiations, one of the key topics for the Japanese supervisors was the definition of capital to be used in calculating capital adequacy. More specifically, they sought to continue the possibility for Japanese banks to include unrealised profits on shareholdings. With the Japanese initially aiming for 70 per cent of these gains to count as capital (as was already domestic practice), the US and especially the UK objected (because their banks were not allowed this practice under domestic accounting rules).³⁵ This issue was so important for the Japanese banking sector that their association even petitioned the Fed directly on this issue.³⁶ The bargaining among the three states resulted in a 45 per cent weight

towards capital of unrealised gains. This result was quite agreeable for the Japanese, since their huge stock market gains during the 1980s ensured that a 45 per cent weight would allow their banks, among other things, to reach the 8 per cent capital adequacy ratio.³⁷ This was the ratio that was starting to emerge as the standard in the parallel BCBS negotiations. By September 1987 the three countries reached a trilateral agreement, confirming the risk-weighted assets approach and the two-tier capital structure of the bilateral accord.

After the trilateral accord was reached, negotiations moved to the BCBS in earnest. Smaller BCBS members complained about this process, among them Markus Lusser, vice-president of the Swiss National Bank, who remarked that "the willingness to co-operate internationally could suffer damage in the long run."³⁸ The late appearance of the BCBS as the policymaking institution had meant the exclusion of the voices of the small G10 countries in the policymaking process so far.

In the subsequent negotiations, the 'non-triad' members of the BCBS sought measures to accommodate specific issues relevant to their domestic banking constituency, or complained about exceptions for others. With the broad outline of the Accord already fixed by the trilateral agreement, the main bone of contention was the definition of capital and what could be counted as it. The Germans specifically pushed for a stricter definition of capital. For many other countries, the interest of domestic banking constituencies took the lead, with the French, for example, pushing for the inclusion of loan loss reserves (which the French banks had accumulated to a significant amount in the aftermath of the Latin American debt crisis).³⁹ The second tier of capital proved useful here to accommodate national differences, while maintaining a strict capital definition for the first tier.⁴⁰

The BCBS banking supervisors reached broad agreement by December 1987, and put out a 'consultative paper'. During this consultative round, the BCBS consulted with non-G10 banking supervisors while domestic banking regulators used it as a formal opportunity to discuss the draft accord with their banking industry.⁴¹ The consultative round only led to minor revisions, with the largest ones being championed by the US (inclusion of perpetual non-cumulative preferred stock in tier 1 capital) and France (same risk weighting for bank credit extended to all banks in the OECD, not only OECD home country banks).⁴² The reaction of the private sector in the various countries was relatively subdued, because they hoped they could satisfy their preferences in the national policymaking institutions where the implementation of the Accord would be carved out (mistakenly, it turned out).⁴³

²⁹ Off-the-record interviews with public actors, 1992.

³⁰ Wood, 2005, p. 74 - 81.

³¹ Reinicke, 1995, p. 171.

³² Chey, 2006, p. 68.

³³ Chey, 2006, p. 70. The 70 per cent figure was based on past stock market volatility, but effectively leads to what Chey calls 'cosmetic compliance' when you compare it to the (later) Basel standard.

³⁴ Chey, 2006, p. 68.

³⁵ Wood, 2005, p. 78.

³⁶ Reinicke, 1995, p. 172.

³⁷ Chey, 2006.

³⁸ Cited by Reinicke, 1995, p. 169.

³⁹ See Underhill, 1997, p. 30.

⁴⁰ Off-the-record interview with a public actor, 1998. See also Reinicke, 1995, p. 173 and Tarullo, 2008, p. 57.

⁴¹ Responses by the private sector might have been limited because they were taken by surprise when the BCBS managed to reach an international agreement (off-the-record interview, 1992).

⁴² Tarullo, p. 55 (footnote 16).

⁴³ Reinicke, 1995, p. 175.

In July 1988, the final accord (with the title ‘International Convergence of Capital Measurement and Capital Standards’) was agreed on by the governors of the G10, adding a strong global level component to the governance of the banking sector. The BCBS explicitly linked the issue of safety and soundness of the banking system and the issue of levelling the competitive playing field. The Accord comprised some 25 pages with rules for capital adequacy, and its implementation phase ran until 1992.

The Basel I Capital Accord is consequently a risk-weighted capital adequacy standard reflecting a number of political compromises and the situation in the global banking sector at the time. It uses two tiers of capital, the first (core capital) consisting of shareholders’ equity and disclosed reserves. The second tier consists of various other sorts of secure capital, such as revaluation reserves, loan loss reserves, hybrid capital instruments, undisclosed reserves and subordinated debt. The Japanese lobby for inclusion of unrealised gains on securities is reflected in the restriction that asset revaluation reserves that take the form of latent gains on unrealised securities are subject to a discount of 55 per cent. Banks are required to hold 8 per cent of capital against the risk-weighted outstanding assets (with a minimum tier 1 capital/asset ratio of 4 per cent).

Risk weights were assigned according to class of asset and varied from 0 per cent (cash, OECD government debt, local currency government debt) to 100 per cent (claims on the private sector, claims on non-OECD government in foreign currency). These risk weights clearly show the origins of the Accord in the 1980s Latin American debt crisis, with loans to non-OECD countries indiscriminately weighted at 100 per cent as compared to 0 per cent for OECD countries’ sovereign debt. The fact that none of these non-OECD countries sat at the table during the negotiations will surely have made this feature less controversial in the negotiations. At the same time, this also provides banks with an incentive to lend to OECD countries instead of to non-OECD countries. The market position of state debtors from OECD countries thus improved. The Accord also dealt with certain types of off-balance sheet items like lines of credit and underwriting facilities by counting them as assets (with a discount), and then putting them into the 100 per cent risk category.

A number of points are noteworthy in the policymaking process and resulting Accord. First of all, Basel I implied an important shift ‘upwards’ in the jurisdictional dimension of governance. The G10 countries basically agreed to a governance pattern emanating from the BCBS, and this was later followed by many non-G10 countries. For the first time, the globalisation of the banking sector was followed by a shift upward of governance to the international level. On the second dimension of the nature of governance, Basel I is mostly public. It was implemented by public bank supervisors without much room for (private) bankers’ input. The Accord was negotiated by public sector actors in the BCBS, without significantly enhancing or reducing private sector influence on the supervision of banks.

On the stringency dimension, Basel I did entail a restraint of banks’ room for manoeuvre (as had been the intention from the start), especially compared to the unregulated

Euromarkets. For many countries, the implementation of formal capital adequacy standards was new, and the required level of capital at 8 per cent was higher than it often used to be. On first sight, also the calculation of the required capital was relatively inflexible with the fixed categories and weights having the consequence of constraining banks’ flexibility in addressing risks in their balance sheets. However, as will become clear in the next section, this proved less restraining than it might appear.

This outcome in the sense of shifting patterns of governance can be explained by the particular interaction between preferences (interests), ideas and policymaking institutions in the policymaking process. The discussion above showed that the preferences of US authorities were heavily shaped by both the fact that the Latin American debt crisis had brought their banking system to the brink of bankruptcy and by domestic political dynamics that led to a push for more stringent capital adequacy standards. Banks, on the other hand, saw this as an opportunity for international harmonisation (and hence not only levelling, but also virtually opening up the playing field). In the international policymaking process, a consensus had already started to emerge pointing to a lack of (risk-weighted) capital as the problem, focusing the discussion around the idea of a risk-weighted capital adequacy standard. Moreover, the US steered the policymaking process to institutions conducive to its views. These preferences consequently came together in policymaking ‘institutions’ dominated by the US (initially in the form of bilateral and later trilateral negotiations), although in the final phase of the negotiations it moved to the BCBS in earnest.

In the following section, the impact of Basel I on the terms of competition and market structure is discussed. Furthermore, the adjustments to the Accord over the course of the 1990s are discussed.

The interlude: Basel I feeding into the market structure

Basel I provided a number of incentives for actors, changing the terms of competition in the market (and consequently the market structure). The Accord gave an impetus to the further internationalisation of the banking sector because the costs of doing international business were reduced by harmonisation. This meant new entrants on domestic markets, or, looking from the global market perspective, rising inter-firm competition. A second impact on the terms of competition was that Basel I provided incentives for banking market consolidation, again affecting inter-firm competition. Thirdly, the Accord provided an incentive for market innovations such as the use of capital market instruments and off-balance sheet activities. This changed the nature of the banking business and blurred the line between different market segments in the global financial system.

First turning to the internationalisation trend: this had already been going on for several decades in the wider context of financialisation (as has been discussed in chapter three). As

can be seen in table 4.1 below, the internationalisation of the banking sector held steady over the course of the 1980s, and accelerated for most countries in the second half of the 1990s (some years after the phasing in of Basel I). The envisaged 'levelling of the playing field' seem to have had a limited immediate impact on internationalisation, therefore.⁴⁴ On the other hand, it could also be noted that the Latin American crisis had not led to a retreat to the home market (unfortunately data for the 1985 - 1990 period, which shows a reduction, does not include emerging market claims). Furthermore, some private sector representatives did report in 1992 that international competition was more intense due to Basel I.⁴⁵ In general, banks were increasingly active on international markets and consequently experienced increasing international competition as well.

Table 4.1. Foreign claims of banks in selected OECD countries (% GDP)⁴⁶

Country	1983	1985	1990	1995	1998*	1999*	2000	2005
Belgium	7	13	10	13	14	152	172	239
Germany	5	9	9	11	18	80	98	100
France	13	16	9	10	13	58	59	83
Italy	3	4	3	5	5	22	26	20
Japan	5	14	12	9	8	24	25	36
Netherlands	5	11	9	16	35	98	105	260
UK	18	18	9	21	23	58	72	108
US	6	5	2	3	3	7	7	8
Sweden	3	3	3	3	4	35	59	137
Switzerland	16	29	18	19	31	359	386	519

* Note: break in data series, see footnote Source: BIS consolidated banking statistics, table 9B

A second trend in the banking sector was consolidation, leading to ever bigger financial conglomerates (see table 4.2). This trend could be the result of the increasing competitive pressure resulting from the supervisory harmonisation under Basel I.⁴⁷ This had important consequences for the global banking markets. Consolidation provided economies of scale in risk management departments, allowing further specialisation and sophistication.⁴⁸ The rise of the use of VaR models to get detailed risk assessments of the positions of banks was a reflection

⁴⁴ In an off-the-record interview (1992) a private actor claimed that the levelling effect of Basel I was limited. See also Wood, 2005, p. 88-89.

⁴⁵ Off-the-record interview with private actor, 1992.

⁴⁶ Between 1998 and 1999 the definition of 'foreign' was widened by the BIS (to include emerging markets). This leads to a 'jump' in the trend. The table shows the increase in the international position of banks notwithstanding this 'jump'.

⁴⁷ Llewellyn, 1989, p. 46, paraphrased in Wood, 2005, p. 90. Groeneveld, 1999 inter alia also points to the influence of international harmonisation of regulation.

⁴⁸ This was also noted by supervisors at the time, e.g. Bank of England, 13 March 1992, p. 5. In light of the 2007-2009 events, sophistication almost sounds ironic, however.

of this. For example, JP Morgan reached a wide audience with its RiskMetrics service based on VaR models (promoted extensively from 1994 onwards).⁴⁹ This development shows the increasing consensus within the banking sector (especially large US banks) that these kinds of models were the right way to assess banks' riskiness and hence their necessary capital buffer.⁵⁰

Table 4.2. Banking sector concentration (five biggest banks as % of total assets)

	1985	1990	1995	1999
Belgium	48	48	51	77
France	46	43	41	43
Germany	n/a	14	17	19
Italy	n/a	29	32	48
Netherlands	73	73	76	82
Sweden	81	83	87	88
UK	n/a	n/a	28	29
US*	17	20	26	37**

* Concerns biggest 10 banks ** Data for 1998

Source: ECB, 2000, table 2.1 (Europe) and Rhoades, 2000, table 15 (US)

The most direct – and arguably most important – response to Basel I was the rise in the use of off-balance sheet instruments. Off-balance sheet activities (specifically those that were not included in the consolidation measures in Basel I) like securitisation became more interesting as they carried only a limited or no capital charge at all. This further fuelled a proliferation of complex financial instruments and increased the importance of derivatives trading. An off-the-record interview source from a large internationally active bank even went as far as to cast doubt on the market efficiency of these financial innovations, instead pointing out that they mainly exist to address 'regulatory inefficiencies'.⁵¹ In general we can say that there was a trend towards an originate-to-sell model, where banks made their money from fees instead of from interest rate spreads. Table 4.3 below reflects this trend at G10 banks. This changed the terms of competition by blurring borders between market segments and rewarding those banks that were able to compete across a number of market segments (e.g. through capital market access).

⁴⁹ Holton, 2002. Prior to 1994, JP Morgan had used this model itself.

⁵⁰ In an off-the-record interview one private actor stated "I believe in VaR models because I don't think the regulators have a better idea (...) I think the JP Morgans, the Goldmans and the Merills do - as much as anyone can - understand their risks."

⁵¹ Off-the-record interview with private actor, 1992.

Table 4.3. Non-interest income as % of total income for G10 banks⁵²

	1980	1985	1990	1995	2000	2005
Belgium	n/a	18	18	29	49	40
Canada	n/a	n/a	30	33	53	51
France	n/a	n/a	23	46	61	62
Germany	20	21	27	21	36	34
Italy	n/a	26	22	20	36	32
Netherlands	26	26	28	33	47	46
Sweden	26	31	24	35	57	57
Switzerland	48	47	49	57	63	61
US	25	30	30	32	40	41

Source: OECD banking statistics

Next to the changes in the terms of competition discussed above, which were reflected in the developments in market structure, on the regulatory front the European Union continued its efforts at supranational supervisory convergence. Supervisors had already gone beyond the Banking Directive, which was mentioned in chapter three. Reflecting the close ties and good cooperation between bank supervisors (often central banks), they had panned out agreements on how to deal with differences in supervisory approaches in different countries.⁵³ After implementing the Basel Accord, European supervisors continued harmonisation by looking at market risk (in addition to the traditional credit risk focus of Basel I).

This European lead on this issue was a result of the specific market structure in continental Europe. Where in the US (and in countries whose financial regulation was similar to the US system) the Glass-Steagall Act separated commercial banking from investment banking, no such separation existed in continental Europe. This meant continental European banks often traded in securities within the same entity that also accommodated the traditional banking activities. They were consequently confronted not only with traditional credit risk (the risk of a creditor defaulting), but also with market risks (the risk of a sudden decline in the value of securities held by a bank). Capital market activities were thus already a continental European tradition in ‘universal banks’.

Since Basel I was only a minimum standard, there were no objections to the Europeans to address this development by adding a market risk element to the supervisory standard of the Basel I Accord. European supervisors thought such an addition necessary in light of the integration of the market for investment services that was strongly pushed by the private sector.⁵⁴ In 1992, therefore, the European Community agreed to a Capital Adequacy Directive (CAD). This

⁵² Numbers are for all banks and hence dilute those for the most sophisticated, internationally active banks. Data for Japan and the UK are not available in the OECD database.

⁵³ Off-the-record interview with public actor, 1992.

⁵⁴ Off-the-record interview with public actor, 1998.

translated Basel I into an EU directive, but as mentioned also included elements of market risk.⁵⁵

Shortly after the European Community had agreed on a way to address market risk, the BCBS also revealed a consultative proposal for a market risk amendment closely mirroring the CAD proposal (which is not surprising as these amendments were developed in parallel).⁵⁶ The reason the BCBS followed the European lead and also developed a preference for adequate regulation in this field was the increasing desegmentation (meaning the banking and securities market became increasingly interwoven) in the global financial system that was now occurring globally – as also mentioned above.⁵⁷ With the increasing cross-sector integration in the financial system, market risks also become increasingly important for banks.

The 1993 BCBS consultative proposal especially requested comments from market participants, and this request was extensively fulfilled by market participants. In first instance, the BCBS proposed a standardised approach to market risk, akin to the approach of Basel I. According to private actors, however, the standardised approach was too simple. One particular strong demand from the market participants was therefore to use VaR models in the assessment of market risk.⁵⁸ The work on this amendment was finished by 1996, and it can be seen as an important step towards the regulatory philosophy enshrined in Basel II later on; the use of internal VaR models was allowed (within strict limits).⁵⁹ This also meant that Basel I plus the market risk amendment (Basel I.5) covered more and more of banks’ activities, as the trading book was growing absolutely and proportionally.

This short description of the policymaking process concerning the market risk amendment offers an opportunity to take a step back and analyse how the trends in the terms of competition and market structure mentioned above influenced the preferences of actors with respect to the governance of bank capital adequacy.

For private actors, the market structure showed the emergence of a segment of globally active and increasingly large banks. These banks were diversified and made use of ‘sophisticated’ risk management tools based on models like the VaR model. Banks always had a preference for holding less (expensive) capital buffers, but with the models they could build the intellectual case for why Basel I overstated risks and hence the capital buffers. Moreover, the concurrent use of own (supposedly superior) models to calculate capital and a separate calculation for regulatory capital imposed an administrative burden on business. The large, internationalised banks consequently developed a preference for the use of internal models to determine regulatory capital and increasingly began to push for a full renegotiation of the Basel I Capital Accord.

⁵⁵ Wood, 2005, p. 95. The Capital Adequacy Directive formally passed into European law in March 1993, Directive 93/6/EEC.

⁵⁶ Off-the-record interview with public actor, 1998.

⁵⁷ Underhill, 1995.

⁵⁸ Off-the-record interviews with public actors, 1998.

⁵⁹ See Tarullo, 2008, p. 60-64 for an account of the policymaking process on the market risk amendment.

For public supervisors, the changing market structure also led to an adjustment of their preferences when the impact of Basel I on the market became clear. For example, a working group of the BCBS conducted a review study (finished in April 1999) analysing the impact of the Basel Accord on the banking sector as well as the broader macroeconomy.⁶⁰ This study roundly concluded that:

*“The available evidence suggests, therefore, that the volume of regulatory capital arbitrage is large and growing rapidly, especially among the largest banks (...) there are indications that in many cases the effect [of securitisation] is to increase a bank’s apparent capital ratio relative to the riskiness of its actual book, which is making the ratios more difficult to interpret and in some cases less meaningful.”*⁶¹

The crude risk categories and their weightings influenced the incentive structure for the allocation of bank capital considerably. Basel I provided incentives for banks to move into business that would not increase their risk-weighted capital reserves. Furthermore, within each asset class, banks would have the incentive to seek the highest yield (and thus the most risky assets within the class). Public bank supervisors consequently realised that the Basel I governance pattern could underestimate risks in the banking sector.

In discussing regulatory capital arbitrage, a researcher from the Fed pointed out that it was mainly the large banks that were involved in this activity, through securitisation. Non-mortgage securitisation by the 10 largest US banks as of March 1998 was more than 25 per cent of the institutions’ total risk-weighted loans.⁶² He concluded:

*“recent financial innovations and the 1997 Market Risk Amendment raise the prospect that such arbitrage may expand dramatically in the coming years (...) they highlight the importance of seeking ways to more closely align regulatory measures of risk with bank’s true economic risks. Absent greater convergence, regulatory capital standards seem destined to become increasingly distorted by financial innovation and improved methods of RCA [Regulatory Capital Arbitrage] – at least for those large, sophisticated banks having the resources to exploit such opportunities.”*⁶³

In short, changes in the structure of banks undermined the aims of Basel I from a supervisory perspective. As an off-the-record public actor stated: “as they [the banks] were developing these more sophisticated tools they were both using them to manage their own risks, but it also shed light on where the Basel I rules were dramatically overstating or understating

capital and therefore provided a nice toolkit to also arbitrage the hell out of Basel I.”⁶⁴ This realisation led to an adjustment of public actors’ preferences.

Although the market risk amendment was a step towards more risk-sensitive approaches under Basel I, large internationalised banks still found the standard increasingly constraining. The G30 played an important role in promoting a consensus in the international policy community that a new international supervisory model was necessary. Most important in this respect was their high-profile study ‘Global institutions, national supervision and systemic risk.’⁶⁵ In this report, they also advocated the use of internal models. Although public actors in a first reaction to the report resisted the suggestion that the G30 provided a ready-made solution, they did accept the wider premises of the report and the need for further consultations.⁶⁶ Another prominent push came from the private sector through a 1998 report from the IIF working group on capital adequacy: ‘Recommendations for revising the regulatory capital rules for credit risk’ – a proposal to allow banks to use their own models.⁶⁷ These reports prepared the global level groundwork for a renegotiation of Basel I.

As mentioned above, both public officials and private sector representatives’ preferences had already started to change. However, there were still prominent reservations among supervisors. In February 1998, the Dutch central banker Tom de Swaan (chairperson of the BCBS), delivered a speech at a high-profile New York conference on the future of regulatory capital stating: “the advances made by market participants in measuring and modelling of credit and other risks are potentially significant and should be carefully studied on their applicability for prudential purposes and might at some point be incorporated into capital regulation. But before we reach that stage, there are still formidable obstacles to be overcome.”⁶⁸ De Swaan’s term as chair was ending, however, and the emerging coalition for renegotiation received an important push when the chairmanship of the BCBS was handed over to William McDonough of the New York Federal Reserve in June 1998.⁶⁹ The New York Fed had been one of the principal proponents of the model-based approaches.

Over the years the effects of Basel I on the terms of competition in the banking sector had severely changed its structure (for example, the rapid increase of securitisation) and hence its governance preferences. At the same time there was an increasing congruence of the outlook on the problem definition (regulatory arbitrage) and the possible yardstick (market-based risk management models) to measure the solution against among prominent international policymakers (consisting of these private sector representatives and several G10 banking

⁶⁴ Off-the-record interview with public actor, 2008.

⁶⁵ G30, 1997. See Tsingou, 2007 for a more extensive treatment of the role of the G30 in global financial governance.

⁶⁶ Off-the-record interview with public actor, 1998.

⁶⁷ Tarullo, 2008 discusses the importance of this report.

⁶⁸ DNB, 27 February 1998.

⁶⁹ The significance of the change in chairpersonship was pointed out to me by several off-the-record interviews with BCBS insiders, and is corroborated by Tarullo, 2008, p. 91.

⁶⁰ Jackson et al., 1999.

⁶¹ Jackson et al., 1999, p. 26.

⁶² Jones, 2000, p. 48.

⁶³ Jones, 2000, p. 51.

supervisors). This culminated in the decision by the BCBS in July 1998 - in the first meeting under MacDonough's chairpersonship - that a new Capital Adequacy Framework would be negotiated.⁷⁰

Renegotiating the Basel Capital Accord into 'Basel II'

As the above made clear, the renegotiation of Basel I started with a much higher degree of international consensus about the direction of the negotiations (e.g. reflected in the G30 position). The new Accord should strive for a comprehensive assessment of bank risks, based on internal risk management models. The renegotiation was also less driven by US domestic politics, with full negotiations starting at the level of the BCBS (without previous bilateral and trilateral negotiations) in response to changing preferences of G10 supervisors and large international banks.

This central position of the BCBS as the policymaking institution was also a new element in the negotiations. As will be shown below, this influenced the policymaking process in important ways through the skewed argument pool and close group coherence that the BCBS implies. On the other hand, supervisors increasingly felt they were meeting like-minded people, in contrast to discussions in their domestic policymaking processes.⁷¹

As a reflection of the firm entrenchment of the BCBS as the global level policymaking institution over the course of the 1990s, an important change vis-à-vis the negotiations on the first Basel Accord was the formal open consultation process managed by the BCBS secretariat. These consultations took place in three rounds, and were very transparent (the second and third consultative papers and the responses from interested parties can be found on the BIS website).⁷² These formal consultations allowed private interest groups to petition the BCBS directly, as opposed to lobbying through domestic policymaking institutions. The latter had been the modus operandi during the policymaking process leading to Basel I.⁷³ In theory, the open consultations allowed many stakeholders to express their preferences to the BCBS. In practice this turned out rather differently, as will be demonstrated below.

With respect to the broader goals of the Basel Capital Accords, it appeared that supervisors aimed to add two policy goals to the new Accord (as the first consultative paper of June 1999 elaborated). The traditional two goals from the first Basel Accord (safety and soundness and competitive equality) were complemented by two other goals: a comprehensive approach to addressing risk and a focus on internationally active banks – although also being applicable to other banks. The first of these new goals seems to be based on the intellectual case that had

⁷⁰ Tarullo, 2008, p. 91.

⁷¹ Off-the-record interview with public actor, 1992. Baker, 2006, describes a similar dynamic in the G7 meeting of finance ministers and central bank governors.

⁷² www.bis.org. Unfortunately, the responses to the first consultative paper have not been published.

⁷³ Off-the-record interview, 1992.

been built for renegotiation (the superiority of VaR models in addressing different risks), as well as the increasing market integration. This comprehensive approach potentially also would influence the stringency of the Accord, as the more types of risk are included, the more banks are constrained in their activities.

Interviews with policymakers involved in the negotiations pointed to several issues of contention in the negotiations (both between different supervisors and between supervisors and the banking sector).⁷⁴ The discussion below will be structured around four such topics, which are representative of the wider political economy and governance issues related to the negotiations. The first topic concerns the use of ratings and internal models, the prime innovation of the new Accord. The second topic concerns operational risk, a new risk category that supervisors wanted to add to Basel II to live up to the aim of being a comprehensive risk approach.⁷⁵ The third topic was the treatment of specific national idiosyncrasies in the financial sector (including the issue of the implications of the new Accord for non-G10 countries). The fourth topic was the pro-cyclicality of the Accord, the extent to which the specific set-up of the Accord amplified the economic cycle.

The latter issue of pro-cyclicality can be addressed rather briefly for the purposes of this discussion. Pro-cyclicality concerns the fear that a risk standard based on ratings would squeeze credit in an economic downturn because of the deterioration of ratings, hence contributing to the further deepening of the downturn.⁷⁶ This issue was somewhat debated in the press coverage of the Basel negotiations. However, several BCBS insiders claimed that the committee never paid too much attention to it because every bank capital adequacy standard would be pro-cyclical in some form or other.⁷⁷ It apparently was mainly a bone of contention for academics, not so much for policymakers.⁷⁸

The first consultative paper (CP1) came out in June 1999 and proposed a three pillar approach: capital adequacy requirements in the first pillar (with the 8 per cent capital requirement untouched), rules for the supervisory process in the second pillar, and the third pillar laying down measures with the aim of using market discipline to counter excessive risk-taking. CP1 stated unequivocally that “the new framework should at least maintain the current overall level of capital in the system.”⁷⁹ It furthermore pointed out that the standardised (akin to Basel I) and model-based approaches should be consistent, in other words there would be no advantages in terms of capital requirements from using one approach over the other.

A first contentious topic in the ensuing policymaking process concerned the use of ratings and internal models. The first consultative paper introduced the use of external ratings,

⁷⁴ See the annex with data sources. The interview data is largely consistent with the accounts of Wood, 2005, and Tarullo, 2008.

⁷⁵ See also Power, 2005 on operational risk.

⁷⁶ See for example Griffith-Jones, Pratt & Segoviano, July 2003; Claessens, Underhill & Zhang, 2008.

⁷⁷ Off-the-record interview with public actor, 2007.

⁷⁸ Off-the-record interviews with public actors, 2008.

⁷⁹ BCBS, June 1999.

and mentioned the IRB approach. Only a very cautious step was taken towards model-based approaches, however. CP1 states that the BCBS “recognizes that for some sophisticated banks use of internal credit ratings (...) could contribute to a more accurate assessment of bank’s capital requirement.”⁸⁰ At the same time, the paper promised further steps in that direction, which was rather curious as many official actors involved had signalled that an internal ratings-based approach would demand significantly more study.⁸¹ The Swiss supervisors, for one, apparently did not believe in the use of models for regulatory purposes at all.⁸² However, it seems in the BCBS they focused on demanding higher capital requirements and not so much debated the model-based approach.⁸³ This could indicate the influence of groupthink with respect to the model-based approach.

The reactions to CP1 reflected disappointment on the side of the industry, which had a strong preference for the use of internal models. Several international associations, such as the IIF and the International Swaps and Derivatives Association (ISDA) pushed for more refined risk categories, and pointed out that internal ratings might be superior to external ratings in this refined approach.⁸⁴ The main external rating agencies (Standard & Poor’s and Moody’s) also responded hesitantly towards their newly assigned prominence in the governance pattern for bank capital adequacy. This can be attributed to their fear of newcomers on their turf⁸⁵ and thus provides a concrete example of how market participants try to influence the policymaking process and resulting governance pattern in order to maintain their competitive position. More importantly, both banking representatives and external rating agencies thus lobbied for using internal ratings rather than external ratings.

The second topic of contention concerned operational risk. It appeared that after having already included market risk in the Basel I Accord, the supervisors also wanted to include operational risk in the risk-weighted capital. This preference of supervisors follows from the regulatory philosophy of the Accord: to come up with a comprehensive risk-weighted standard as well as the experience of the collapse of Barings bank due to a rogue trader (Nick Leeson). This topic seemed to pit public supervisors working from a ‘theoretical’ perspective against the private banks seeking to reduce constraints, however. Since this type of risk ranges from rogue traders to earthquakes, it is hard to model and quantify in a market-oriented fashion. The banking sector was consequently hesitant about institutionalising this risk category in the Basel supervisory framework and preferred to address this type of risk in the course of ‘normal business.’⁸⁶ When the negotiations had been launched, large internationalised banks had thought that the BCBS would work towards their own internal models, but now the committee

proposed to add capital requirements for a new type of risk. Banks opposed this, claiming operational risk was already part of the regular business process (and thus did not need to be institutionalised).

The third topic concerned national idiosyncrasies and had already flared up before the first consultative paper was published. An important contentious issue was the treatment of mortgage loans.⁸⁷ Germany’s peculiar mortgage market structure was accommodated by a supervisory system where commercial mortgages received a low risk weighting, and the Pfandbriefe from special mortgage banks received a low risk weighting as well. However, it was feared by other banks that both these measures would give German banks a competitive advantage in the international mortgage market. Germany was supported by the French and Spanish in trying to maintain the low risk weights, while the US together with the UK and Italy opposed it. The infighting between official delegations in the BCBS on these issues delayed the first consultative paper with several months. CP1 provided a compromise by leaving room for national exceptions on mortgages (or so the text was interpreted by the Bundesbank).⁸⁸ These preliminary skirmishes mainly reflected traditional, national level idiosyncrasies being protected by public officials.

The access to the BCBS of large, international banks paid off in the further policymaking process: many of the comments and discussions were taken aboard in the second consultative paper (CP2) of January 2001. CP2 was a much more detailed document (including supporting documentation it came to over 500 pages), but at the same time kept intact important elements from the first proposal such as the three pillar approach. Besides leading to a new round of discussions on the issues already identified in the first consultative round (such as operational risk), new issues were added to the discussion as well. Supervisors stumbled upon new issues as they went along.⁸⁹ The second consultative paper contained a crucial step in the direction of more market-oriented supervision mechanisms: it set out not one but two proposals for the use of internal ratings by the banks (the Foundational and the Advanced Internal Ratings Based approaches).

Extensive informal consultation with the private sector took place continuously at the domestic level and – more importantly – increasingly at the global level.⁹⁰ For example, interviews with the IIF revealed that there had been meetings at the highest level (i.c. Nout Wellink, chairman of the BCBS) concerning Basel II. These meetings were also initiated by the BCBS secretariat, which asked the private sector for ‘help’ in developing proposals.⁹¹ CP2 also acknowledged this private sector influence: “The Committee has developed an approach

⁸⁰ BCBS, June 1999.

⁸¹ Tarullo, 2008, p. 95/96.

⁸² Off-the-record interview, 2008.

⁸³ Interview with representative of the Swiss public sector, 2008.

⁸⁴ Off-the-record interviews with BCBS insiders.

⁸⁵ The Economist, 27 November 1999.

⁸⁶ Off-the-record interview with public actor, 2008. See also Tarullo, 2008, p. 98 and Wood 2005, p. 136.

⁸⁷ This has proven to be a sensitive issue in many emerging markets as well, according to several interviews with emerging market public actors in 2007/08.

⁸⁸ Wood, 2005, p. 130.

⁸⁹ Off-the-record interview public actor, 2008.

⁹⁰ Off-the-record interviews with public and private actors, 2008. The extensive consultations with the private sector on global financial governance is also clear in the sets of interviews of the early and late 1990s.

⁹¹ Interview with IIF representative, 25 June 2008, Washington DC.

to regulatory capital that more accurately reflects a bank's individual risk profile. Work with industry associations and data collected through surveys have been essential to the development of a risk sensitive IRB approach."⁹²

The effect of the extensive involvement of large international banks was most clearly reflected in the fact that the overall capital objective in CP2 only talked about maintaining the current level of overall capital for the standardised approach. For the 'sophisticated' banks, which could use the advanced approach, a temporary floor of a 10 per cent reduction in capital requirements during the first two years was set.⁹³ Such a reduction of capital would lead to a competitive advantage for large international banks over smaller competitors under the standardised approach.

Coming back to the four topics for discussion, supervisors obviously had incorporated private sector preferences with respect to risk models. The objections of credit rating agencies had been noted: national credit rating agencies were added as a second source of external ratings next to the traditional rating agencies. Furthermore, under the standardised approach, more risk categories were added to increase risk sensitivity. The extensive yet preliminary proposals for the IRB approaches proved the source of most discussion. The IRB was very much applauded by the largest international banks, which at the same time increased fears of the other banks that the Accord might hamper a level competitive playing field. The models of the IRB approach still had to be calibrated further, so it was unclear what the eventual effect of the IRB approach on bank capital adequacy levels was going to be.

To allay these fears, the BCBS conducted a series of Quantitative Impact Studies (QIS). Some months after the release of CP2, the second QIS was concluded. The results of this study are summarised in table 4.4 below, showing the change in capital requirements for diversified, internationally active banks (group 1) and smaller or more specialised banks (group 2). The outcome of the second QIS was surely problematic. Not only did it lead to overall capital increases (instead of maintaining capital levels, as was originally promised), the capital increase under the foundational approach was even higher than under the standardised approach. Clearly, further calibration of the models was needed in the eyes of private actors (and also public actors given the inconsistent results).

Table 4.4. Results of QIS2

	Standardised		Foundation IRB		Advanced IRB	
	credit	overall	credit	overall	credit	overall
Group 1	6	18	14	24	-5	5
Group 2	1	13				

Source: Tarullo, 2008, p. 112 (table 4.2)

⁹² BCBS, January 2001, para. 93.

⁹³ BCBS, January 2001, para. 48 and 49.

Noteworthy (especially with the benefit of hindsight) was that in the academic literature the dangers of using a model-based approach were already pointed out.⁹⁴ The 1997 East Asian crisis had provided empirical backing of the main criticism on the models: the standard relationships on which these models are based break down in periods of financial crisis (as the current financial crisis once again demonstrates). The LSE's Jón Daniélsson also brought this to the fore in a response to CP2.⁹⁵ Alas, this seems to have been to no avail. Negotiations on the model-based approach continued undisturbed. Within the narrow policy community that was discussing Basel II, voices providing significantly divergent opinions seemed to have been ignored in a process of groupthink.

With respect to the second topic (operational risk), supervisors had not been deterred by private sector lobbying in making a specific proposal for an operational risk capital charge. CP2 set out an approach to operational risk that to some extent mimicked the whole Basel II approach: a basic approach using a relatively simple indicator, a standardised approach that offers more flexibility to the banks and an internal measurement approach.⁹⁶ This already allowed much more flexibility to the sophisticated category of banks, yet still met with strong opposition from the financial sector. Bankers feared that they would lose on the front of operational risk what they gained in market and credit risk, i.e. increased flexibility and a more tailor-made approach vis-à-vis capital requirements.⁹⁷ This might actually have been the objective of the supervisors. One BCBS insider provided a second-hand account in which operational risk was presented as a sort of backhander to European supervisors concerned about low capital requirements coming out of the IRB approaches.⁹⁸

The third contentious topic of national idiosyncrasies was one of the points where supervisors 'stumbled upon' new issues. Using external ratings could have a negative effect on lending to Small and Medium-sized Enterprises (SMEs). Since few companies in Europe and Japan, especially SMEs, have such a credit rating, these would therefore get a 100 per cent risk weighting. This meant that lending to SMEs would become more expensive. With an election campaign in Germany underway, suddenly the issue of banking regulation rose to the highest levels of public attention. Chancellor Schröder intervened and made clear he would veto any European banking directive based on Basel II: Germany would not accept an Accord leading to higher borrowing costs for the *Mittelstand*.⁹⁹ This policy discussion was not prompted by private sector responses to CP2; SME associations only started responding to CP3.¹⁰⁰ In the BCBS German opposition was supported by Japan and other continental European countries.¹⁰¹

⁹⁴ Daniélsson, 2002 and 2008; Persaud, 2000.

⁹⁵ Daniélsson, 31 May 2001

⁹⁶ Tarullo, 2008, p. 108.

⁹⁷ Off-the-record interview with public actor, 2008.

⁹⁸ Off-the-record interview with public actor.

⁹⁹ Financial Times, 1 November 2001, p. 12.

¹⁰⁰ E.g. the submission to the BCBS by Eurochambres.

¹⁰¹ Off-the-record interview public actor, 2008.

The topic of national idiosyncrasies was furthermore reflected in the treatment of credit card debts. Credit card debts are a substantial part of the balance sheet of especially American banks. A high risk weighting of these debts would force the US banking sector to hold relatively larger amounts of reserve capital than their global counterparts. Given the implications for the competitiveness of the US banking sector, this issue became a possible deal-breaker for the American representatives in the negotiations.

With difficult issues accumulating and given the aforementioned problematic quantitative impact results of the model-based approach, it is perhaps not surprising that in December 2001 the BCBS announced that it would need further work on the draft Accord before posting a new consultative paper.¹⁰² It specifically mentioned that it would work on three issues. First, balancing the need for a risk-sensitive Accord that was sufficiently clear and flexible (so that banks could use it effectively). Second, ensuring that the Accord treats credit to SMEs appropriately. Third, calibration of the minimum capital requirements to bring about a level of capital that, on average, would be approximately equal to the requirements under Basel I (while providing some incentive to those banks using the more risk-sensitive internal ratings-based system, i.e. the possibility of lower capital requirements). Interestingly, the launch of an Accord Implementation Group was also announced, further strengthening the role of the BCBS in banking supervision and signalling that an agreement would be forthcoming.

The Committee also pointed out that the dialogue with market participants on several issues (such as securitisation) was still ongoing. And this proved to be very true: during June 2001 and with the release of the third consultative paper, the BCBS issued 10 substantive proposals on specific elements of the IRB approach for discussion and consultation with the banking sector.¹⁰³

A Committee meeting in July 2002 delivered breakthroughs on several of the contentious topics.¹⁰⁴ It was decided that capital charges would only apply to unexpected losses (keeping most credit card debts out of the agreement). Credit card debts were thus to be covered by charging higher interest rates or bad loan provisions (as was already standing practice by banks). SMEs' concerns were accommodated by giving unrated companies a lower risk weighting than low-rated companies.¹⁰⁵ It became clear that the BCBS was bowing to some of the pressures coming from some national governments (Germany in the case of SMEs), politicians and the financial sector (on the issue of operational risk). These breakthroughs were subsequently put forward for consultation in the third consultative document.

After all these painstaking discussions, the third consultative paper (CP3) did not contain significant surprises with respect to the model-based approach, as adjustments and

¹⁰² BCBS, press release, 13 December 2001.

¹⁰³ Tarullo, 2008, p. 114.

¹⁰⁴ BCBS, press release, 10 July 2002.

¹⁰⁵ This introduces a strange incentive into the Accords for low-rated companies to no longer apply for a rating and in doing so possibly reduce their costs of borrowing.

specifications had been floated for discussion beforehand (as mentioned above). With respect to the second contentious topic of operational risk, the supervisors had given in even further to the banking sector. This is because negotiations were bogged down on so many issues that some progress had to be made. Only a very low capital requirement was set, and this requirement could be easily circumvented by the banks. Consequently, governance on this specific issue shifted almost completely to the sophisticated banks themselves. National idiosyncrasies were mostly addressed through the breakthrough compromises mentioned above. Interestingly, the BCBS also claimed that the agreement on SMEs would diminish any pro-cyclical effect.¹⁰⁶

As became clear from the discussion of the policymaking process above, the consultative paper process proved to accommodate the preferences of private sector parties. A closer look at the inputs received in the process helps to explain why. Due to the opaque and supposedly technical nature of the policy domain, the responses to the consultative papers are predominantly from international banks/bankers' associations or other financial services firms (see table 4.5 below). The second large group of responses comes from official banking supervisors from countries not represented in the BCBS. In about 30 per cent of the cases these were explicitly drafted in consultation with or on behalf of their domestic financial sectors. The other comments came from, for example, International Financial Institutions and individual academics (and curiously: one CSO from the Bronx).¹⁰⁷

So although this open consultative process would make it very easy in principle for actors to join in the policy discussions, in practice the actors actually exerting influence were mainly the financial sector, banking supervisors and IFIs. This points to the effect of 'groupthink': apparently it is hard for other stakeholders to link up to the discourse in this policymaking process.

Table 4.5. Responses to BCBS consultative papers (% of total)

	CP2	CP3
Supervisory authorities	18	20
Private financial actors	70	66
Private non-financial actors	3	4
Other	10	10
<i>total number of responses</i>	257	186

Source: www.bis.org (author's classification)

¹⁰⁶ Off-the-record interview.

¹⁰⁷ As it turns out, this CSO might have delivered one of the most prescient comment letters: it pointed to the dangers of subprime mortgages. Inner City Press Community on the Move & Fair Finance Watch, 30 July 2003.

The BCBS itself had established a subcommittee in the form of the International Liaison Group. This group met with senior supervisors from 16 major (non-G10) countries to get early input on its discussions. Furthermore, regional groupings of bank supervisors were invited to participate in the work of BCBS subcommittees. This served to feed viewpoints from a wider set of countries into the BCBS itself ‘without overburdening the efficiency of its work processes’ (as an interview source put it).¹⁰⁸

The G10 central bank governors approved the Basel II framework in June 2004. Basel II was to be implemented four years after it was initially scheduled and after seven years of consultations and negotiations. The Accord was far more complex than the Basel I version, and comprises over 250 pages of detailed regulations. As mentioned, the Accord consisted of three pillars. The first pillar set minimum capital requirements, and allows sophisticated banks to use their own internal risk models (the single most important demand of the internationalised large banks). This signified a shift in the pattern of governance towards more private forms of governance. For banks lacking the necessary sophisticated risk models, basically an adjusted version of the Basel I framework still applies. The second pillar provides for continued dialogue between supervisors and banks in order to deal with the idiosyncrasies of individual banks and situations. This institutionalises the position of banks in the implementation of the Accord by domestic level banking supervisors.¹⁰⁹

The third pillar enhances bank transparency with the idea of exposing banks to the discipline of the market, again signifying a shift towards market-based governance. Interestingly, it seems that representatives of the financial sector took issue with the disclosure requirements under pillar 3. An off-the-record representative of the private sector claimed the disclosure might not enable the markets to compare risk profiles between banks. The private sector was therefore working on a self-regulatory framework to ensure a functioning third pillar.¹¹⁰

The formal implementation of the Basel II framework was planned to commence at the end of 2006. A new element in the implementation efforts of the BCBS was an institutionalised working group focused on the implementation of the Accord both in the G10 and in emerging markets. Its aim was to improve effective global implementation and it further entrenched the role of the BCBS as a policymaking institution.

Notwithstanding the BCBS’ efforts, implementation first ran into some trouble in the parliamentary process in different G10 member states. The European Commission drafted the third Capital Adequacy Directive that passed the Basel II framework into European financial services law in record time. In response “the European Banking Federation hailed the ‘unprecedented level of consultation’ that preceded the proposals.”¹¹¹ In the US, on the other

hand, Congress took issue with the possible reduction of capital requirements as a consequence of Basel II. It went so far as to threaten to stop the implementation of Basel II in the US altogether, to the dismay of the IIF.¹¹² American banking regulators had already signalled in 2003 that they would delay full implementation of the Accord to 2008 and beyond, and would only apply it to about the 20 largest American banks. At the start of the current crisis, Japan was the first and only G10 country claiming to have fully implemented all pillars of the Basel II Capital Accord.¹¹³

The crisis knocked further implementation in other countries off the rails, and even led to significant renegotiations to a Basel III Capital Accord (see the discussion in the Conclusion). Although it thus cannot be established what the impact of Basel II on the terms of competition was, it is worth noting that a 2006 Ernst & Young study showed that three-quarters of banks believed Basel II would change the industry’s competitive landscape, as large groups with the most sophisticated risk-modeling systems benefit at the expense of those who have been slower to adopt these systems.¹¹⁴

Analysis and preliminary conclusions

This chapter traced the shifts in the governance of bank capital adequacy over the course of the 1980s and 1990s and has shown the accompanying changes in the market structure. As the market structure changed, governance preferences of both private and public actors adjusted, which fed back into the policymaking process. At the same time, the new pattern of governance under the Basel I regime led to a new set of incentives in market competition that significantly changed the market structure. Below the shifts in governance along the three dimensions are discussed first, which will work towards addressing the first research question (how has the pattern of governance shifted in the policy domain). The second subsection continues by discussing the relationship between these shifts and the market structure through an analysis of the policymaking process. This addresses the second and third research questions on the characteristics of the policymaking process and the relationship of patterns of governance and changing market structures.

Shifts in governance from Basel I to Basel II

The pattern of governance for bank capital adequacy has shifted in a number of important ways across the three dimensions set out in the second chapter. The first dimension

¹⁰⁸ Off-the-record interview, see also www.bis.org.

¹⁰⁹ It must be acknowledged, however, that this sort of consultation most likely was already standard practice of banking supervisors.

¹¹⁰ This interview statement is corroborated by Tarullo, 2008, p. 111.

¹¹¹ Financial Times, 15 July 2004.

¹¹² Financial Times, 15 November 2005.

¹¹³ Interviews with Japanese public actors, November 2007. At the time, the policymakers ensured me that this was one of the reasons why Japan got through the crisis relatively unscathed. This situation has obviously changed significantly since then, making this claim seem somewhat like wishful thinking.

¹¹⁴ Ernst & Young, 11 April 2006.

of governance distinguished concerned the jurisdictional level. On this dimension, the governance pattern as established under Basel I is a shift upwards as it brought the members of the G10 together under a harmonised capital adequacy standard. The governance of bank capital adequacy had shifted from the national to the international level. Although other countries (outside of the G10 plus the EU member states) have on occasion adopted Basel I as well, the Accord was not intended *ex ante* to become a global level Accord and the BCBS did not put much effort into achieving this.

Basel II therefore signified a shift upward on the jurisdictional dimension to the global level. It formally applied in first instance to the G10 countries (and by extension to the European Union member states), but explicitly aimed to apply on the global level. Already during the negotiations many non-G10 states signalled their intention to implement Basel II. Other states were incorporated into the Basel process through the International Liaison Group. Furthermore, a special working group (the AIG) was established to aid in global implementation. Finally, the IMF was used to promote global implementation of Basel II through its FSAP surveillance. The Basel II Accord was thus clearly geared towards becoming a global level governance pattern versus the international level on which Basel I was located at the onset.

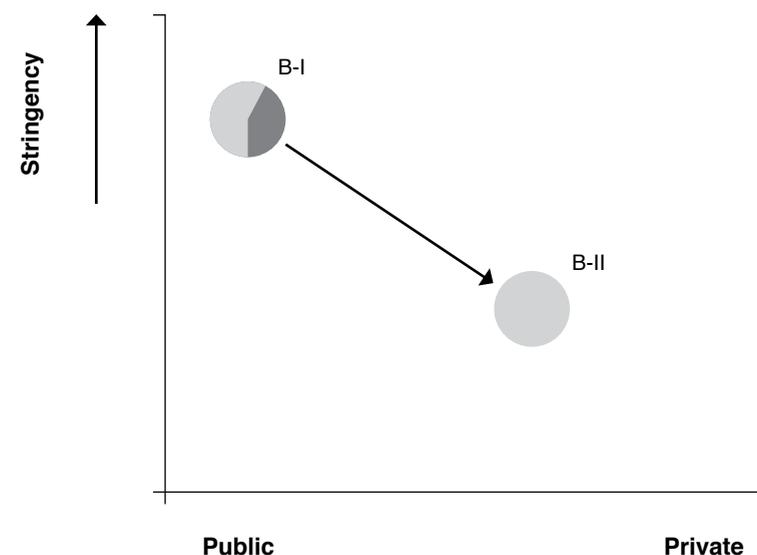
With respect to the second dimension of governance, its nature, Basel I can be characterised as a governance pattern dominated by public institutions and authority. The rules were set by public authorities, as were the calculations necessary to determine the capital adequacy ratio. The implementation was to be achieved by national level public bank supervisors with a small role for private sector self-regulation or input. Basel II shows a shift towards more private, market-based types of governance. The implementation of bank capital adequacy standards is now a mixed responsibility of private actors (which run the models) and public supervisors (which determine parameters and check the outcomes), as opposed to the public implementation of the Basel I risk-weighted capital requirements.

On the third dimension, Basel I was relatively stringent for banks (especially compared to the more informal supervision that seems to have been the norm previously). It set an 8 per cent capital charge against risk-weighted capital, which seems to be significantly higher than the level banks were subject to before the implementation of Basel I. This risk-weighted capital was calculated through five categories, hence seemingly constraining banks' flexibility in addressing risks in their balance sheets. Basel II shows a shift towards more discretion for banks under the IRB approach (and less so under the standard approach). This allows banks to use their own risk model (under certain parameters) and is consequently less constraining on their operations by more closely tying regulatory capital to actual bank activities. It also likely provided the banks applying the advanced IRB approach with a competitive advantage.

In figure 4.1 below, the relative shifts in governance from Basel I to Basel II are schematically illustrated. The vertical axis represents the stringency dimension (the further from the zero-point, the more stringent), while the horizontal axis depicts the type of governance dimension (public at the zero-point, adding more private elements the further we move away

from the zero-point). The pie chart in the circles representing the Basel I and II governance pattern reflects the jurisdictional dimension: a larger lightly shaded area represents a shift upward to the global level.

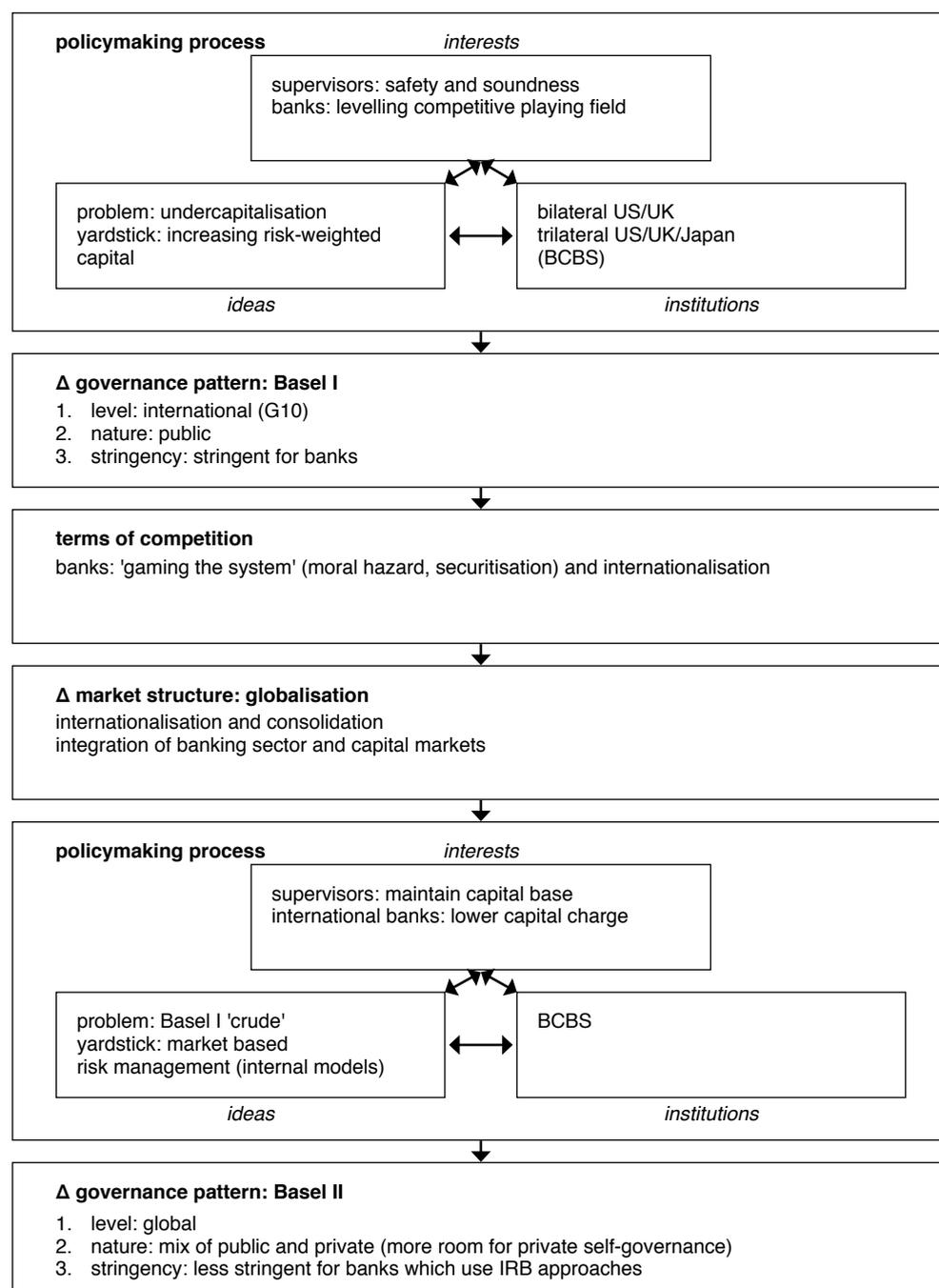
Figure 4.1. Shifting patterns of governance: Basel I to Basel II



The dynamic in the market for banking and its governance

To sum up the shifts in governance, compared to the Basel I Capital Accord, Basel II entails a shift upwards on the jurisdictional dimension, and shifts towards a more private nature and less stringent governance. In this subsection, these shifts in governance are analysed from the theoretical perspective developed in chapter 2. The following analysis is focused on the time period of this chapter and thus 'steps into' the feedback loop at the point where the first Basel Accord was being negotiated. In the concluding chapter the analysis from this chapter will be extended with that of chapter three, including the developments of the 1970s. Figure 4.2 on the next page shows the feedback loop that was introduced in the first chapter (figure 1.1) is represented in a linear fashion, making one and a half 'rounds'. Starting from the policymaking process in the 1980s (leading to Basel I) we move to the shifts in governance Basel I entailed and on to the changes in terms of competition and market structure (first full round). Subsequently the (partial) 'second round' starts with the negotiations on Basel II and ends up with the shifts in governance the Basel II pattern of governance entailed. In the following, this feedback loop will be elaborated.

Figure 4.2 Linear representation of the feedback loop between market structure and governance pattern in the case of bank capital adequacy standards



The interaction between the preference of US public actors for a stringent pattern of governance, with the preference of the US private sector to maintain or regain their international competitiveness explains why the US tried to negotiate an international level governance pattern. After failing to convince the BCBS of the need for an international agreement, the US in a sense sought to create a 'policymaking institution' in which its preferences would prevail. This succeeded in bilateral negotiations with the UK, which shared the US supervisory philosophy of risk-weighted capital requirements. This effectively set the yardstick to measure any BCBS solution against: capital requirements based on a risk-weighted capital ratio. The bilateral agreement – and inherently the threat of exclusion from the predominant global financial centres – led Japan to overcome its reluctance towards capital standards. A trilateral agreement was negotiated which saw Japan guaranteeing its banks' competitive position would not be hampered through the inclusion of unrealised equity gains in bank capital.

Only after the three main actors had reached an agreement, negotiations shifted to the policymaking institution of the BCBS, and soon after that the 1988 Basel I Capital Accord was announced. The specific combination of public preferences for a stringent pattern of governance and private preferences for international competitiveness led to two goals for Basel I: the safety and soundness of banks and levelling the international competitive playing field. The new set of incentives provided by Basel I to market actors had a significant impact on the terms of competition and subsequently the market structure. It gave banks the incentive to engage in regulatory arbitrage from off-balance sheet activities like securitisation. Furthermore, the levelling of the playing field encouraged consolidation in the banking sector and further internationalisation. At the same time, bigger banks had better abilities to 'game the system' through the complex risk management systems they developed (VaR models).

This changing market structure also had an impact on the preferences of actors. The large, internationally active banks increasingly expressed a preference for using their own internal risk models, which would lead to better risk management than under Basel I. They used influential reports by global level interest associations such as the IIF and think tanks like the G30 to develop an international consensus surrounding this more risk-sensitive approach on the policymaking agenda. Supervisors maintained their preference for a safe and sound banking system but realised banks were 'gaming the system', circumventing the safeguards of Basel I. The BCBS emerged as the policymaking institution in which these shifting preferences coalesced (for example witnessed by the landmark study into regulatory arbitrage conducted by its secretariat). This combination of shifting preferences, emerging consensus on a yardstick (market-based capital standards, i.e. the use of internal models), and a policymaking institution were the most important global level actors came together led to a renegotiation of Basel I.

The fact that the policymaking process took place in the BCBS as the policymaking institution led to the marginalisation of voices from outside the circle of expert financial policymakers, both in domestic politics (e.g. between ministries of finance/central banks and national parliaments

and ministries of social affairs) and in the international policymaking process (other stakeholders than the financial sector itself). The discussions in this global policy community drew on a limited range of arguments (skewed argument pool) with a strong voice of global representatives of large internationalised banks. This is also evident from the consultative papers process that was managed by the BCBS secretariat. Although seemingly offering an open and transparent policymaking process, in fact the responses to the second and third consultative paper were heavily skewed towards private sector preferences (over 60 per cent of responses) with less than 15 per cent of responses coming from actors outside of the policy community of financial experts. Only incidentally did other stakeholders manage to assert their preferences, as we saw with Schröder's intervention on behalf of the *Mittelstand*.

The common outlook on the way forward that had emerged fairly quickly (the use of internal risk models to set capital adequacy standards), did not mean the public sector just responded to private sector demands. On the basis of the intellectual arguments for market-based approach – based on a narrow range of economic theory – the public actors set the goal of a comprehensive approach in addressing risk. In practice, this meant the public actors pushed for an operational risk capital requirement in Basel II over the opposition of private banks.

To summarise the feedback loop that is illustrated by this case study: shifting patterns of governance under Basel I changed the constraints actors faced in their actions in the global banking system, in turn leading to changing market structures. These changes in market structures also led to adaptation of preferences for governance of both public and private actors and led to a renegotiation of Basel I to Basel II. The negotiations on Basel II took place in global level policymaking institutions with a strong bias towards the preferences of large internationalised banks.

Chapter 5

Governing sovereign debt crises: From Latin America to East Asia and back

In this chapter the policymaking process concerning the management and resolution of sovereign debt crises since the 1980s is studied and related to the developments in the market structure of sovereign debt markets. By doing this, this case study sheds light on the relationship between the market structure for sovereign debts and the patterns of governance of sovereign debt crises. Ever since states discovered the benefits of using credit to finance their activities (historically mostly to wage war; more recently to finance war and welfare states) there have been occasions of over-indebtedness and the accompanying inability or unwillingness to repay creditors. These sovereign debt crises are usually accompanied by periods of major domestic economic upheaval. The cumulative decline in economic output in the three years leading to a default is 8 per cent for domestic debt default and 1.2 per cent for external debt defaults. Inflation in the year of default is 33 per cent for external debt defaults and a whopping 170 per cent for domestic debt defaults.¹ Naturally, this economic dislocation has grave social consequences. Also in the current financial crisis, several countries on the periphery of the Eurozone (e.g. Greece, Ireland) have suffered the adverse consequences of economic recession and sovereign debt problems. The governance pattern for sovereign debt crises aims to reduce these costs through an orderly and speedy resolution of these crises.

The analysis in this chapter starts with the resolution of the Latin American debt crisis of the 1980s under the Baker and Brady plans and traces the developments in this policy domain through to the debate on statutory (SDRM) and contractual (CACs) approaches in response to the series of emerging market financial crises in the second half of the 1990s. Five core arguments will be made.

First of all, it will be argued that the governance pattern emerging to resolve the Latin American debt crisis can be characterised based on the three dimensions of governance as an international level, public pattern of governance that was stringent for debtor countries and to a certain extent also stringent for private creditors. The Latin American debt crisis was resolved on an ad hoc, case-by-case basis under two successive US-led plans (the Baker and Brady plans). These plans built on the initial reaction to the crisis, which was to initiate official

¹ Reinhart & Rogoff, 2009, p. 129. Note that this data applies to actual defaults, and hence does not take into account debt crises where no default takes place.