Governance pattern and market structure: the case of banking supervision under the Basel Capital Accords[1]

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ABSTRACT

This paper examines the relationship between market structure and governance patterns in the global banking sector, using the Basel Capital Accords as a case. The policy-making process on the Basel Capital Accords will be traced from the prelude to and negotiations on the first Basel Capital Accord (roughly the period of the 1980s) to the agreement on the Basel II Capital Accord in 2004, with a focus on the interaction of both public and private actors in this process. It will be argued that to understand the shifts in the pattern of governance, we have to analyse the policy-making process by looking at the preferences of both public and private actors involved. These preferences are constrained by both the historical governance patterns (as in the policy-making institutions) as well as by the role of expert knowledge in the policy-making process. While the preferences lead to shifting patterns of governance, these feed back into the market structures and thereby change the preferences of specifically the private sector for the future governance pattern.

Key words: (multilevel) governance, banking supervision, Basel Capital Accords

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Introduction

In this paper the governance pattern regarding (international) banking supervision is analysed. International cooperation on the supervision of banks has centred around the Basel Committee on Banking Supervision (BCBS) and in this paper the specific focus lies on bank capital adequacy standards (the so-called Basel Capital Accords). Arguably, these are the most important element of the global financial architecture for the banking sector. With the current financial crisis, political and popular interest in the supervision of banks has greatly increased. Did supervisors fail in their task of ensuring financial stability? Is the minimum capital buffer for banks of 8% of risk-weighted capital really adequate? Were banks pursuing activities in the 'shadow banking system' which they shouldn't have? While these kinds of questions are understandable and important at the current juncture, this paper takes a step back to analyse the more long-term shifts in the pattern of governance of banking supervision.

The aim of the paper is to show the relation between the market structure in the banking sector and its governance pattern. To this end, the interaction of both public and private actors in the policy-making process is studied. The policy-making process on the Basel Capital Accords will be traced from the prelude to and negotiations on the first Basel Capital Accord (roughly the period of the 1980s) to the agreement on the Basel II Capital Accord in 2004 (where relevant, also some of the aftermath in the national implementation, will be discussed).

It will be argued that to understand the shifting pattern of governance in the area of banking supervision, we have to analyse the preferences of both public and private actors involved in the policy-making process. These preferences of the actors are constrained by both the historical policy-making institutions as well as by the role of expert knowledge in the policy-making process, however. Moreover, there is a two-way dynamic between changes in governance patterns and changes in market structures.

The case laid out below will show how the kind of policy-making institutions that emerged constrained the preferences that are being articulated in the policy-making process. Where the negotiations on Basel I could be characterised as a two-level game, the subsequent further integration of international financial markets and consolidation of the banking sector in global giants led to a push for institutionalisation of the policy-making process at the level of the BCBS and the development of close ties between the internationally active public sector supervisors and the representatives of global banks. Over the course of the Basel Accords, the position of the BCBS thus strengthened, creating a transnational policy community. This transnationalisation of the policy-making institutions gives international financial actors a strong position in the discussions. The exclusionary nature of this policy community and claimed ‘technical’ decisions taken reduce the influence of other actors.

Secondly, it will also show how the policy discussion was framed by the policymakers converging on the problem definition (ensuring adequate supervisory capital *and* levelling the competitive playing field) and yardstick to measure the solution against.[2] This led to the emergence of a dominant supervisory paradigm focussed on risk-weighted capital standards, which effectively excluded other ideas for renewing the global bank supervisory framework. The articulation of interests in the emerging transnational policy community has hence been influenced by a skewed argument pool, constraining the arguments and policy proposals actors can meaningfully make in the policy-making process.

The two aforementioned elements constrain the actors in the political process in expressing their preferences. When applying this to the case, it becomes clear how shifts in governance change market structures, and how these new market structures lead to new preferences regarding the governance pattern. This illustrates the two-way dynamic explaining shifts in governance in the field of international banking supervision.

The governance of the international banking system can be seen as a multilevel governance pattern.[3] The main levels are domestic and global, with the EU playing an important role as a regional level of governance. However, analytically we should disentangle several dimensions of such a multilevel governance pattern. When looking at the jurisdictional reach of governance, we see that although the formal reach has not been changed (the Accord is still between the G10 countries), in practice the reach to other jurisdictions has increased. It appears that many non-G10 countries (including many emerging markets) are very keen to implement the Accord.[4] This extends the jurisdictional reach of the Accord and implies (for the countries not previously implementing Basel I) a shift upwards for the governance

[2] It hence resembles the expert communities as conceptualised by Ikenberry, 1992.
[3] See Baker, Hudson & Woodward, 2005.
[4] As also became apparent from the interviews with emerging market policy makers. However, question marks can be raised about the actual compliance of many countries with the Accord, see Chey, 2006.

pattern. Looking at the nature of governance from the perspective of the public/private continuum, it continues to be the public BCBS from which the rules emanate. However, as will be elaborated below, the involvement of the private sector in the policy-making process has increased significantly.

It will become clear from the empirical material laid out in this paper that the most significant change has taken place in a third dimension of governance: how constraining the rules are. The international rules for bank capital adequacy have changed from a relatively crude and command-and-control-like Basel I to much more market-based techniques for supervision. Instead of prescribing the measurement and amount of supervisory capital, sophisticated international banks are to a large extent allowed to use their own internal risk models under the most advanced approach. At the same time market forces are explicitly enlisted in supervision by increasing transparency towards investors about capital adequacy. Both these elements are in accordance with the preference for market-based forms of governance of the most powerful actors in the policy community and the dominant philosophy on banking supervision among the experts involved in the policy-making process.

The paper is set up as follows. First the historical background to the negotiations on Basel I is shortly discussed (section 1). The rapid internationalisation of the banking sector was accompanied by the emergence of some form of capital adequacy regulation in many G10 countries. Officials grappled with this new structure of the banking sector, while the banks themselves became more aware of the possible international competitive implications of their domestic supervisory regimes. The Latin American debt crisis gave especially the American public sector officials a strong sense of urgency to strengthen bank supervisory standards. As discussed in section 2, this led to the negotiation of a global banking supervisory standard, enshrined in the first Basel Capital Accord. The negotiations were driven by the US, hence the US regulatory preference for capital adequacy regulation dominated the discussion. Especially since the US started with bipartite (US-UK) and tripartite (US-UK-Japan) before the whole BCBS membership got seriously involved. As a consequence, on the international level it was very much a state-based process, with the BCBS as an international negotiation forum of G10 banking supervisors. Only in the very last instance, the draft Accord was sent out for global consultations by the BCBS. Section 3 discusses the interlude between the conclusion and implementation of Basel I and the start of formal negotiations on Basel II. It shows the important impact Basel I had on the structure of the banking sector. It also tracks the further development of supervisory thinking on capital adequacy measurement, which was for example reflected in a major amendment to the Basel I Accord (the market risk amendment of 1996). As a result of the impact of the new Basel I governance pattern on the global banking system, increasing tensions developed in this interlude. June 1999 this led to the announcement of formal negotiations on a renewed capital accord, the dynamics of which are discussed in section 4. As this section shows, the process was much more complicated, with extensive consultations and a highly advanced model as the regulatory ambition. Conclusions from this case for the relation between market structure and governance pattern are drawn in the last section.

The historical context of the Basel process

International banking expanded rapidly from the 1970s onwards, for example shown by the expansion of foreign bank subsidiaries in the main financial capitals (table 1 below). This rapid expansion was accompanied by a number of high-profile bank failures with an international dimension. Banks had to get used to managing the risks of currency volatility, and supervisors had little idea how to ensure burden sharing during financial rescue operations. A prominent example was the 1974 Bankhaus Herstatt crisis. This bank was first of all brought down by currency speculation gone wrong (and which it had tried to cover up fraudulently). More importantly, when the day of reckoning came, the German supervisors decided to close the bank down at a time in the day where Bankhaus Herstatt had received its Deutsche Mark payments on current transactions, but had not yet paid its counterparts in the currency transactions.[5] This brought counterpart banks all over the world in trouble, almost shutting down the interbank market for credits.

Table 1. Spread of international banks: foreign bank representation in major financial capitals.

	1970	1975	1980	1985
London	181	335	402	482
New York	75	127	253	326
Tokyo	64	115	139	170

Source: Tschoegl, 2000, table 1 (p. 7).

[5] Helleiner, 1994, p. 173 (footnote 17).

The bank failures of the period at a minimum pointed to the need for more information sharing and greater cooperation among bank supervisors (instead of the ad hoc approach followed at the time). On the instigation of the governor of the Bank of England (BoE), the G10 central bank governors established a Standing Committee on Banking Regulations and Supervisory Practices (now known as the Basel Committee on Banking Supervision, BCBS) in 1974 to deal with these issues.[6] The objective of the BCBS is currently "to improve supervisory understanding and the quality of banking supervision worldwide", but in its initial phases the BCBS concentrated its efforts on closing "gaps in the supervisory net".[7] The first gap to be closed was the division of work between home country and host country supervisors, to prevent subsidiaries of banks to escape from supervision or an unduly administrative burden on internationally active banks. Already in 1975 the BCBS agreed on the Basel Concordat delineating supervisory responsibility between home and host country supervisors.

Parallel to the internationalisation of the banking market, capital ratios of banks started to decline (see table 2 below for data on the US). This was especially pronounced for internationally active banks (such as the 17 largest US banks in table 2).These decreasing capital ratios provoked increasing interest among G10 banking supervisors in light of the safety and soundness of their home-country banks. Although in most cases no formal capital requirements were set, bank supervisors increasingly asked banks to provide them with information on their capital adequacy ratios. Many supervisors (including the American) had historically used capital adequacy ratios[8] Formal capital adequacy standards would force banks to keep a specific amount of capital in reserve for credit risks (forming a buffer in case of defaults), and are usually seen as burdensome by banks. However, at the time the supervision of the safety and soundness of banks was usually based on a variety of approaches other than their capital ratios. For example, the US' Federal Deposit Insurance Corporation (FDIC) used a gearing ratio, determining the regulatory capital based on total bank balance sheet value. The Japanese supervisors, on the other hand relied on the so-called convoy system, where healthy banks were persuaded to incorporate banks in trouble if need

[6] Kapstein, 1994, p. 44.
[7] BIS, 2006, p. 1.
[8] Kapstein, 1994, p. 106/107.

be without setting formal standards on individual banks. The UK, interestingly, already moved to a risk-weighted capital adequacy ratio in 1980.[9]

Table 2. US bank capital ratios, 1970 – 1981 (percentage of equity capital to total assets)

Year	1970	1975	1980
All banks	6.58	5.87	5.80
17 largest banks	5.15	3.94	3.69

Source: Tarullo, 2008, table 2.1 (p. 32)

The increasing interest in capital standards by G10 regulators also enticed the BCBS to conduct some conceptual work, seeking to achieve "greater convergence among its members with regard to national definitions of bank capital for supervisory purposes."[10] However, the G10 Governors explicitly did not want a convergence of the capital standards, they just wanted to prevent a deterioration of the capital levels.[11] This was mainly due to the perceived problems in harmonisation at the global level, no the least bit because of strong opposition from domestic banking interests.[12]

More significantly, in the European Community there were initiatives to harmonise banking supervision under the programme to integrate European markets (the '1992' agenda). These initiatives had already started in 1973, culminating in the adoption by the European Council in 1977 of the First Banking Coordination Directive.[13] This directive combined agreements on home-host country issues within the European Community with some preliminary steps towards harmonisation of supervisory standards. The Directive required supervisory authorities to "establish ratios between the various assets and/or liabilities of credit institutions with a view to monitoring their solvency and liquidity and the other measures which may serve to ensure that savings are protected". However the establishment of these ratios was "for the purposes of observation" and next to possible domestic measures used.[14] Furthermore, there is no mention of a specific target ratio or the ratios being risk-weighted. The Directive represents a very cautious shifting upwards of the governance of the banking

[9] Reinicke, 1995.
[10] BCBS, 1981, quoted in Norton, 1995, p. 183.
[11] Norton, 1995, p. 183.
[12] Reinicke, 1995, p. 166.
[13] First Council Directive 77/780/EEC of 12 December 1997 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.
[14] Directive 77/780/EEC, article 6.1.

sector in the European Community. Significantly, next to protection of savers, the Directive aims to create equal conditions of competition between banks in the European Community.

The internationalisation of the banking sector, and the broad decline in capital adequacy was put in the spotlight during the Latin American debt crisis. The potentially disastrous effects of the Latin American debt crisis on the banking sector "stemmed not from bank's evasion of supervision, but rather from bank's assumption of risk without adequately insuring themselves against the worst consequences thereof."[15] This crisis' effects on international banks underscored that the new international banking environment posed more challenges than the Basel Concordat was able to counter. As is so often the case, a major financial crisis was necessary to reach a breakthrough in global financial governance. On the other hand, it also put to the forefront the different approaches supervisors took (with possible consequences for 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 deduction of a portion of the loan losses.[16] The American approach, on the other hand, implicitly meant promoting IMF funding of the debt-laden emerging markets to ensure the American banks loans were eventually repaid.

However, the enormous amounts necessary for this wide-ranging crisis necessitated a capital increase for the IMF. This meant US Congress needed to vote on the American quota increase for the IMF, giving it leverage over the implications of this debt crisis for the international governance of the financial system. For domestic constituency reasons, US Congress would only agree to large-scale official refinancing of the debtor countries if the American banking sector would subsequently face stiffer regulation. The banking sector resisted this forcefully, with the vice chairman of Chase Manhattan Bank stating "a tighter web of administrative controls 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."[17] The initial proposals to Congress would have implied a domestically implemented supervisory regime for banks that would have imposed additional costs on the banking sector relative to its foreign competitors. The American banking sector resisted these domestic standards forcefully therefore, and were

[15] Wood, 2005, p. 68.
[16] Kapstein, 1994, p. 103.
[17] Quoted in Reinicke, 1995, p. 145.

supported in that by the Governor of the Fed, Paul Volcker.[18] This powerful lobby led Congress to strike a deal in which the Fed got the mandate to seek for international agreement on minimum capital adequacy standards.[19]

The initial impulse for negotiating a shift in governance to the global level was hence in two ways the result of the developments in the banking sector of the time. First and foremost, the internationalisation of bank lending to emerging market countries had led to a global financial crisis. Western banks were brought to the brink of systemic failure, increasing the urgency to find governance mechanisms to improve the safety and soundness of banks. But secondly, the internationalisation had led to a global competitive playing field. On this global playing field, differences in domestic standards for supervising the banks, as well as the processes used to ensure the safety and soundness could lead to competitive (dis)advantages over banks in other countries. These forces combined to give the supervisors a strong incentive to strengthen the supervisory framework, while the banks had an incentive to stimulate international convergence of supervisory frameworks. This was further strengthened by the EU project to create European markets by shifting governance to the regional level.

With this as a starting point, the following sections aim to show how the (constrained) interests of the actors determine the policy making outcome in terms of the governance pattern, and how this subsequently constrains the interests of actors in new ways. The immediately following section will look at the negotiations on the first Basel Capital Accord.

The negotiations on the first Basel Capital Accord

The push for a global level governance regime was thus due to the interaction in the domestic US policy community between Congress, supervisors and banks in which the interests of the private actors led to a dual focus on 'safety and soundness of banks' and 'levelling the international competitive playing field'. As a result of this domestic compromise in the US, its representatives in the BCBS proposed negotiating an international agreement on capital adequacy standards. In first instance this was not very enthusiastically received by most other members of the BCBS. As Kapstein quotes an insider: the American proposal "was greeted

[18] Reinicke, 1995, p. 107.
[19] Oatley & Nabors, 1998.

with a yawn."[20] Although several BCBS supervisors were working with the concept of capital adequacy standards, each had their own views on the necessity of formal, internationally coordinated capital standards. Besides, as mentioned above, the European Community had already embarked on their own supranational regulatory project (notably with a similar dual focus of soundness and competitiveness).

However, the Bank of England was less sceptical than most BCBS members. They supervised the European financial capital with the largest presence of American banks (see table 1 above), and more important had already moved to a risk-weighted standard (the American system was even inspired by the UK one).[21] The BoE was thus willing to negotiate a bilateral agreement with the US (hesitations about the developments on this front in the EU might also have played a role[22]). The private sector in both countries encouraged the bilateral deal, being aware of the competitive inequalities caused by different supervisory standards.[23] The negotiation of a bilateral accord would lead to a regional level pattern of governance, including the two single largest global financial centres. Since both the US and the UK were already working with quite similar capital adequacy standards, they managed to reach an accord in relatively short time, completing it in January 1987. This bilateral agreement incorporated the risk-weighted approach and a two-tier capital structure. The latter means that there was base primary capital (stocks, retained earnings, general reserves and some other items) and a second tier of limited primary capital including for example some types of subordinated debt. The second tier capital could not exceed half of total base capital in counting towards the capital adequacy ratio.

The US-UK agreement served as a strong incentive for the other members of the G10, and specifically Japan as the third financial superpower, to overcome their initial reluctance to come to a multilateral agreement. Then they would at least be able to influence the final Accord, e.g. regarding important national exceptions.[24] Furthermore, there was the not-always-subtle threat emanating from the US-UK Accord of closure of the world's two foremost financial centres to banks under diverging supervisory standards. The global market structure with London and New York as the leading financial centres hence constrained the

[20] Interview quote in Kapstein, 1994, p. 108.
[21] Wood, 2005, p. 75-76.
[22] Kapstein, 1991.
[23] Reinicke, 1995, p. 168.
[24] Wood, 2005, p. 74 - 81.

rest of the world in that they needed access to these markets, even if it meant accepting in their eyes less relevant supervisory standards.

The US-UK agreement laid the basis for the subsequent negotiations as the BCBS decided in January 1987.[25] For the US and the UK, however, firstly the focus lay on trilateral negotiations with 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 already recognized that a too large deviation from the trend in other G10 countries could lead to problems and started designing their own capital standards.[26] To imitate the other countries standards without actually raising capital standards for the Japanese banks, banks were allowed to count 70% of unrealised stock market gains as capital.[27] The US-UK agreement encouraged the Japanese supervisor to continue working on a capital standard, especially since the threat of exclusion apparently materialized. The banking licenses for several Japanese banks wanting to enter the American market were postponed, supported by several policy statements by American and British policy makers aimed at getting the Japanese supervisors to fall in line with the Anglo-Saxon discussion.

The bilateral deal hence 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.[28] In the trilateral negotiations, one of the key issues for the Japanese supervisors was the definition of capital to be used in calculating the capital adequacy requirement ratio. More specifically, they sought to continue the possibility for Japanese banks to include unrealised profits on shareholdings. With the Japanese initially aiming for these gains counting for 70% as capital (as was already domestic practice), the US and especially the UK objected (also because their banks were not allowed this practice due to domestic accounting rules).[29] This issue was so important for the Japanese banking sector that their association even petitioned to the Fed directly on this issue.[30] The negotiation resulted in a 45% weight as capital. This result was quite agreeable for the Japanese, since their huge stock market gains during the

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[25] Reinicke, 1995, p. 171.
[26] Chey, 2006, p. 68.
[27] Chey, 2006, p. 70. The 70% 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.
[28] Chey, 2006, p. 68.
[29] Wood, 2005, p. 78.
[30] Reinicke, 1995, p.172.

1980s ensured that a 45% weight as capital would also allow their banks to reach the 8% capital adequacy ratio starting to emerge as the standard in the parallel Basel negotiations. By September 1987, the three countries reached a trilateral agreement, also 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. There, the different other countries sought measures to accommodate specific issues relevant for their domestic banking constituency, or complained about exceptions for others (the Germans for example pushed for a strict definition of capital).[31] 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 interest of domestic banking constituencies took the lead here, with the French for example pushing for the inclusion of loan-loss reserves (which the French banks had significantly accumulated in the aftermath of the Latin American debt crisis).

The G10 banking supervisors reached broad agreement on the multilateral accord by December 1987, and put out a 'consultative paper'. During this consultative round, the BCBS also consulted with non-G10 banking supervisors and domestic banking regulators used it as a formal opportunity to discuss the draft accord with their banking industry. The consultative round only led to minor revisions, with the largest ones being championed by the US (inclusion of perpetual noncumulative preferred stock in tier 1 capital) and France (same risk weighting for bank's credit extended to all banks in the OECD, not only OECD home country banks).[32] The reaction of the private sector in the various countries was relatively subdued, because they hoped the national implementation of the Accord to cater to their interests (mistakenly, it turned out).[33]

In July 1988, the final accord (under the title 'International Convergence of Capital Measurement and Capital Standards') was agreed on by the members of the G10, adding a strong global-level component to the governance of the banking sector. The Accord was comprised of some 25 pages with rules for capital adequacy. The BCBS explicitly linked the

[31] See for example Underhill (ed.), 1997.
[32] Tarullo, 2008, p. 55 (footnote 16).
[33] Reinicke, 1995, p. 175.

issue of safety and soundness of the banking system and the issue of levelling the competitive playing field. The implementation phase of the Accord ran until 1992.

This eventual Basel I Capital Accord is a risk-weighed capital adequacy standard reflecting thus a number of political compromises and the situation in the global banking sector at the time.[34] It uses two tiers of capital, the first (core capital) consisting of shareholders' equity and disclosed reserves. The second tier consists of different 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 unrealized securities are subject to a discount of 55 percent. Banks are required to hold 8% of capital against the risk-weighed outstanding assets (with a minimum tier 1 capital/asset ratio of 4%). Risk weights are assigned according to class of assets and vary from 0% (cash, OECD government debt, local currency government debt) to 100% (claims on the private sector, claims on non-OECD government in foreign currency). The Accord also foresaw in certain types of off-balance sheet items like lines of credit and underwriting facilities which are conversed at a weight to assets, and then put into the 100% risk category.

A number of things are noteworthy in this Accord and the negotiations leading to it. First of all, the risk weights clearly show the origins of the Accord in the 1980s Latin American debt crisis. Loans to non-OECD countries were indiscriminately weighted for a 100% as compared to 0% for OECD countries' sovereign debts. 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.

More importantly, the Accord implied an important shift 'upwards' of the governance of the banking sector. The G10 countries basically agreed to a governance pattern emanating from the BCBS, and this was followed by many non-G10 countries. For the first time, the globalisation of the banking sector was followed by a shift upward of the governance to the international level. The Accord was negotiated by the public sector actors in the BCBS, without significantly enhancing or reducing private sector influence on the supervision of

[34] An updated version of the Accord can be found on the BIS website: www.bis.org/publ/bcbs111.pdf.

banks. As will become clear below, the BCBS functioned as a constant steward of the Accord and was the clear focus for international talks on capital adequacy standards.

As was the intention from the start, the Accord did entail a restraint of bank's room for manoeuvre. For many countries, it was new that formal capital adequacy standards were implemented, and the required level of capital was at 8% 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. However, as will become clear in the next section, this proved less constraining than it might appear.

The interlude: feeding into the market structure

Already during its implementation phase, the Accord was being revised. The minor revisions in the implementation phase partly reflected changes in the banking sector, for example the recognition of netting of off-balance-sheet exposures. This 'tweaking' underscores the growing importance of the BCBS, functioning as a constant steward of the Accord. It also showed the flexibility of the approach taken by the BCBS, not developing international treaties but internationally agreed Accords. Moreover, the increasing importance of the BCBS as the international forum for discussing supervisory standards reduced the influence on the design of bank supervisory standards of public actors at the domestic level which were not represented in the BCBS (e.g. Ministries of Economic and Social Affairs). On the other hand, the supervisors were increasingly constrained in their room for manoeuvre because of their formal or informal obligations in the BCBS.

In the 1990s consolidation in the banking sector continued, credited by some observers to the Capital Accord.[35] This led to bigger, and more internationally active, banking conglomerates (see table 3 for data on the EU) and had important consequences for the supervision on the global banking markets. Consolidation provided economies of scale in risk management departments, allowing further specialization and sophistication. The rise of the use of Value-at-Risk (VaR) models to get detailed risk assessments of the positions of banks was a reflection of this. For example JP Morgan reached a wide audience with its RiskMetrics service based on VaR models (promoted extensively from 1994 onwards).[36] This development shows the increasing consensus within the banking sector (especially the large

[35] Llewellyn, 1989, p. 46, paraphrased in Wood, 2005, p. 90.
[36] Holton, 2002.

banks) that these kinds of models were the right way to asses banks riskiness and hence their necessary capital buffer.

Table 3. Concentration of the banking sector in selected European countries (five largest banks as % of total)

	Assets		**loans**		**Deposits**	
	1990	1995	1990	1995	1990	1995
France	43	41	45	47	59	68
Germany	14	17	14	14	12	13
Italy	19	25	17	26	19	25
Netherlands	73	76	82	81	86	86
Sweden	70	88	65	90	61	84
UK	22	22	31	33	23	24
EU average	*45*	*49*	*46*	*50*	*47*	*52*

Source: Groeneveld, 1999, table 3.

Next to the consolidation, the European Union continued its efforts at regional supervisory convergence with the 1993 Capital Adequacy Directive (CAD). This CAD was a significant development because it added a market risk element to the ‘traditional’ credit risk focus of the Basel I Accord. The reason for this addition was the continental European tradition of universal banks. Where in the US (and in countries whose financial regulation was inspired by its 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 in the same entity as the traditional banking activities. Hence, they were confronted not only with the traditional credit risk (the risk of a creditor defaulting), but also with market risks (the risk of a sudden decline in the value of securities held by a bank). As can be recalled, the Bankhaus Herstatt failure had already illustrated the significance of these market risks. Since Basel I was only a minimum standard, there were no objections to the Europeans to add this market risk element to the supervisory standard of the Basel I Accord.

This issue of market risk hence had always been a point in the continental European banking sector. However, as a result of the influence of the Basel I Accord governance pattern on the banking market structure, it became a much broader concern. The crude risk categories and their weightings influenced the incentive structure for the allocation of bank capital considerably. The Accord provided incentives for banks to move into business that would not increase their risk-weighed capital reserves. Government securities of OECD countries became for example more attractive, while foreign currency loans to non-OECD countries became less attractive (given the background of the capital accord in the 1980s sovereign debt crisis this feature is not surprising). Furthermore, within each asset class, banks would have the incentive to seek the highest yield (and thus the most risky assets within the class). But more importantly, off-balance sheet activities (those which were not included in the consolidation measures described above) like securitisation became more interesting. This further fuelled a proliferation of complex financial instruments and increases the importance of derivatives trading also for the large American banks (Japanese banks were barred from securitisation until 1993).

Following the discussions in Europe and representing both the changing structure in the banking market and the increasing prominence of the VaR philosophy, the BCBS decided to develop a market risk amendment to Basel I as well. Already in 1993 the BCBS released a consultative proposal. This proposal especially requested comments from market parties, and this request was extensively fulfilled by market parties. One particular demand from the market parties was to use the aforementioned VaR models in the assessment of market risk. 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 boundaries). [37]

The market risk amendment was thus a step towards more risk sensitive approaches in the capital standard. However, large, internationalised banks with sophisticated risk management strategies still found the Basel I regulations increasingly constraining. The banking sector increasingly began to push for a re-negotiation of the Basel I Capital Accord. The G30, a think-tank consisting of high-level private sector representatives, public officials, and academics, played an important role in promoting a consensus among experts that a new international supervisory model was necessary. Most important in this respect was their high-

[37] See Tarullo, 2008, p. 60-64 for an account of the policy-making process on the market risk amendment.

profile study ‘Global institutions, national supervision and systemic risk’.[38] The G30 perspective was strongly shared by the NY Fed as the official side ideologue of market-based risk supervision.

The increasing global consensus amongst financial sector representatives and certain powerful supervisors got a new push by a review study conducted by a working group of the BCBS (finished in April 1999) analysing the impact of the Basel Accord on the banking sector as well as the broader macroeconomy.[39] 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.”[40] In short, changes in the structure of banks undermined the aims of Basel I from a supervisory perspective (while also having led to demands from the private sector for a more ‘sophisticated’ approach).

The hand-over of the chairmanship of the BCBS from the Dutch central banker de Swaan to MacDonough of the Federal Reserve in June 1998 supported the building momentum for renegotiation.[41] Over the years the influence of the Basel I Accord on 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 (safety and soundness *and* international competitiveness) to measure the solution against in the transnational policy-making community (consisting of these private sector representatives and the G10 banking supervisors). This culminated in the announcement of the BCBS in June 1999 that a new Capital Adequacy Framework would be negotiated.

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. The new Accord should strive

[38] G30, 1997. See Tsingou, 2003 for a more extensive treatment of the role of the G30 in global financial governance.
[39] Jackson et al, 1999.
[40] Jackson et al, 1999, p. 26.
[41] Off the record interview sources.

for a comprehensive assessment of bank risks. It was also less driven by US domestic politics (although the NY Fed did play an important role in the start of the international debate), with full negotiations starting at the level of the BCBS (without previous bilateral and trilateral negotiations). Another important new element in the negotiations reflected the emerging transnational policy community. As shown above, the BCBS became firmly entrenched as the global level policy-making institution over the course of the 90s, and hence shaped the negotiating space.

An important change vis-à-vis the negotiations on the first Basel Accord was the formal 'open' consultancy process managed by the BCBS secretariat. The 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). [42] These formal consultations allowed private interest groups to petition the BIS directly, as opposed to the main avenue of banks approaching their home governments in the Basel I negotiations. Due to the opaque and supposedly technical nature of the policy domain, the responses to the consultative papers are predominantly from international banks / banker's associations or other financial services firms (see table 4 below). The second large group of responses comes from official banking supervisors from countries not represented in the BCBS. Noteworthy, in a number of cases these were explicitly drafted in consultation with or on behalf of their domestic financial sector. The other comments came from for example Multilateral Financial Institutions and individual academics (and curiously: one obscure NGO from the Bronx). 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 are mainly the financial sector, banking supervisors and IFIs. This points to the effect of the 'expert group' on the negotiations: apparently it is hard for other stakeholders to link up to the discourse in this policy-making process.

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

Table 4. Classification of responses to BCBS consultative papers (% of total)

	CP2	**CP3**
Supervisory authorities	18	20
Of which with sector	*6*	*5*
Private financial actors	70	66
Of which consultants	*14*	*10*
Private nonfinancial actors	3	4
other	10	10
Miscellaneous: total number	257	186

Source: www.bis.org.

However, although the new set-up of the negotiating process partially shaped the policy debate, it did not solve the political issues on the table. Quickly after the announcement of the renegotiation of the Basel Accord several issues of contention arose both between supervisors as well as between the supervisors and the banking sector. As a first issue, operational risk will be treated since the debate on this specific issue seems to reflect the general trend in the discussions rather well.[43] It appeared that after already including market risk in the Basel I Accord, the supervisors also wanted to include operational risk in the risk-weighted capital to make it an even better comprehensive risk measure. Since this type of risk ranges from rogue traders to earthquakes, it is hard to model / quantify in a market-oriented fashion. The banking sector was hence hesitant about institutionalising this risk category in the Basel supervisory framework (without debating its existence).[44] Where initially it seemed to the banks that the BCBS would work towards the use of bank's internal models, now the committee proposed to add a category which could function as a rigid command-and-control measure again. On the other hand, it fits with the regulatory philosophy of the Accord to come up with an all-inclusive risk-weighed standard, even if it went against the direct interests of the private sector (and it hence initially seems to nuance a straight 'capture' story).

[43] See also Power, 2005 on operational risk.
[44] Tarullo, 2008, p. 98. Wood 2005, p. 136.

Despite the initial mutterings of the banking sector, supervisors were not to be deterred on this issue, and a specific proposal for an operation risk capital charge was included in the second consultative document. In the paper, an approach to operational risk was set out which sort of mimicked the whole Basel II approach: a basic approach using a relatively simple indicator, a standardized approach which offered more flexibility to the banks and an internal measurement approach.[45] This already allowed much more flexibility to the sophisticated category of banks, yet met with strong opposition of the financial sector. With the Basel negotiations grinding to a halt on various issues, the supervisors gave in even further in this fight with the banking sector. Hence on this specific issue governance shifted almost completely to the sophisticated banks themselves in the final proposal.

Before the issuance of the first consultative paper, a number of disagreements between mainly Germany and the US officials demanded attention. The contentious issues concerned the use of external ratings (which few German companies acquired, as opposed to most American bigger companies). Another important contentious issue was the treatment of mortgage loans.[46] Germany had a system were also commercial mortgages got a low risk-weighting, and the Pfandbriefe from the special mortgage banks got a very low risk weighting as well. Both these measures would give German banks a competitive advantage over banks from other countries in the mortgage market, it was feared. Germany was supported in these measures by the French and Spanish, while the US together with the UK and Italy opposed. The infighting between official delegations in the BCBS on the issues delayed the first consultative paper with several months. The eventual compromise was found by leaving room for national exceptions on mortgages (or so the compromise text was interpreted by the Bundesbank).[47] These preliminary skirmishes mainly reflected the traditional national level 'varieties of capitalism' or idiosyncrasies being protected by national official delegations. As the subsequent discussion will show, this changed importantly however.

The first consultative paper did come out in June 1999, and it laid a strong foundation for the eventual Accord. The traditional two goals from the first Basel Accord (safety and soundness and competitive equality) were complemented by two other goals: a comprehensive approach

[45] Tarullo, 2008, p. 108.
[46] This has proven to be a difficult issue in many emerging markets as well, according to several of my interviews with emerging market policy-makers.
[47] Wood, 2005, p. 130.

to addressing risk and a focus on internationally active banks – although also applicable to other banks. It proposed a three pillar approach: capital requirements in the first pillar (with the 8% capital requirement untouched), rules for the supervisory process in the second pillar, and the third pillar laying down measures with the aim of imposing market discipline against excessive risk taking. Furthermore, the use of external ratings was introduced (see further below), making a very preliminary step towards refined risk models. 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.[48]

As mentioned above, the reactions to the consultative paper were skewed towards industry experts. Several international associations, such as the Institute of International Finance (IIF) and the International Swaps and Derivatives Association (ISDA) pushed for more refined risk categories ('granularity' in the jargon), and pointed out that internal ratings might be superior to external ratings in this refined approach. Emerging market financial supervisors complained that the refined ratings approach would be a disincentive towards lending to emerging markets. Surprisingly, the main external ratings agencies (Standard & Poor's and Moody's) also responded hesitantly towards their newly assigned prominence. This was attributed to their fear of newcomers on their turf if their position in the banking sector was so enhanced.[49] It became clear that the official experts had been right that a lot more work needed to be done. However, the direction had already been set from the beginning, with the lobbying mostly pointing towards internal ratings instead of external ratings (as opposed to offering a completely new supervisory avenue).

In the discussions on the first consultative paper, also an issue was brought to the fore which would return regularly in the debate on the new Basel Accord: the procyclicality of the Accord.[50] It was feared 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. Although much debated in academia and to a lesser extend the

48 Tarullo, 2008, p. 95/96.
49 Economist, 1999.
50 Claessens, Underhill & Zhang, 2008.

popular press, some claim the committee never paid too much attention to it because every bank capital adequacy standard would be procyclical in some form.[51]

Many of the comments and discussions were taken aboard in the second consultative paper of January 2001. It was a much more detailed document (with the supporting documentation it came to hundreds of pages), but at the same time kept intact the key philosophy from the first document in place (like the three-pillar approach). Many small changes reflected the earlier opposition to elements of the first consultative paper. For example, now national credit rating agencies were augmenting the traditional rating agencies as sources of external ratings. Furthermore, under the standardized approach, more risk categories were added to increase its risk sensitivity.

But besides leading to a new round of discussions on the issues already identified in the first consultative round (such as operational risk), also new issues were added to the discussion. Supervisors stumbled upon problems as they went along (and of course also tried to solve them).[52] The second consultative paper contained another step in the direction of more market-oriented supervision mechanisms: it set out two proposals for the use of internal ratings by the banks (the Foundational and the Advanced IRB approach). Not surprisingly, the extensive yet open proposals for the IRB approach proved the source of most discussions. The IRB was very much applauded by the largest international banks, while at the same time increasing fears of the other banks that the Accord might hamper a level competitive playing field. As the BCBS admitted in the second consultative paper, the IRB approach needed calibration of the models, making the eventual effects of the IRB approach on bank capital adequacy levels unclear. The BCBS has never been able to take away these fears, although the Quantitative Impact Studies were mixed on the effects on these kind of categories of banks and in practice up till today there is no evidence of competitive distortion in this way.[53] A 2006 Ernst&Young study showed that three-quarters of banks believe Basel II will 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.[54]

[51] Off the record interview source.
[52] Off the record interview source.
[53] Interviews with supervisors in several countries, conducted over the course of 2008.
[54] Ernst & Young, 2006. See Bieling & Jager for a critical perspective on the impact on the European economy.

Many representatives of the financial sector also took issue with the disclosure requirements under pillar 3. They claimed they would have to disclose too much proprietary information and/or the disclosed numbers would still not enable the markets to compare risk profiles between banks.[55] Apparently market-based supervision was only wise if that meant supervisors adjusting to the practices of the banking market, but not when it meant exposing banks to capital market discipline…

Two issues proved particularly salient in the further negotiations within the BCBS. It again pitted America vis-à-vis Germany, and led to extensive newspaper coverage of this 'diplomatic row'. The first issue was the treatment of credit card debts, and the second (more important) one was the use of an external ratings system (especially for SMEs). Credit card debts are a substantial part of the balance sheet especially for American banks. A high risk weighting of these debts would force the US banking sector to hold relatively larger amounts of reserve capital than their global counterparts. 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.

European representatives led by Germany and joined by Japan, on the other hand, opposed the suggested external ratings based system. This system links the risk weighting of a company to its credit rating from the rating agencies (Standard&Poor's, Moody's). However, few companies in Europe and Japan, especially Small and Medium sized Enterprises (SMEs), have such a credit rating and these would therefore get a 100% risk weighing. SME associations feared this would increase their borrowing costs, because they would become more expensive for banks to loan to. With an election campaign in Germany ongoing, suddenly the issue of banking regulation rose to the highest 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*.[56]

In December 2001 the BCBS announced that it would need further work on the draft Accord before posting a new Consultative Paper.[57] It specifically mentioned that it would work on three issues. First, balancing the need for a risk-sensitive Accord with its being sufficiently

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[55] Tarullo, 2008, p. 111 and off the record interview source.
[56] Financial Times, November 1, 2001, p. 12.
[57] BCBS, press release, 13 December 2001.

clear and flexible so that banks can use it effectively. Second, ensuring that the Accord leads to appropriate treatment of credit to small- and medium-sized enterprises. Third, finalising calibration of the minimum capital requirements to bring about a level of capital that, on average, is approximately equal to the requirements of the present Basel Accord, while providing some incentive to those banks using the more risk-sensitive internal ratings based system. Interestingly, also the launch of an Accord Implementation Group was announced, indicating that the BCBS was planning to complete a new Accord, despite the criticisms.

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 much true: in the period June 2001 and 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.[58]

A Committee meeting in July 2002 delivered breakthroughs on several of the contentious issues.[59] It was decided that capital charges would only apply to unexpected losses (keeping most credit card debt out of the agreement). Credit card debts are now to be covered by charging higher interest rates or bad loan provisions (as was already standing practice by banks). The German concerns were accommodated by giving unrated companies a lower risk weighting than low-rated companies.[60] It became clear that the BCBS was bowing to the pressures coming from some national governments (Germany in the case of SMEs), politicians, and the financial sector (on the issue of operational risk).

The G10 central bank governors approved the Basel II framework in June 2004. Basel II is to be implemented four years after was initially scheduled and after seven years of consultations and negotiations. As mentioned, the Accord consists of three pillars. The first pillar sets 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 signifies 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

[58] Tarullo, 2008, p. 114.
[59] BCBS, press release, 10 July 2002.
[60] This introduces a strange incentive into the Accords for low-rated companies not to apply for a rating anymore and so possibly reduce their costs of borrowing.

supervisors and banks, 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 baking supervisors.[61] 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. The Accord was far more complex that the Basel I version, and comprises over 250 pages of detailed regulations.

The formal implementation of the Basel II Framework was planned to start end-2006, but has run into some troubles in the parliamentary process in different G10 member states differed. The European Commission drafted the third Capital Adequacy Directive which would put 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".[62] 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 is threaten to stop the implementation of Basel II in the US altogether, to the dismay of the IIF.[63] American banking regulators had already signalled in 2003 they would delay full implementation of the Accord to 2008 and beyond, and would only apply it to about 20 of its largest banks. Currently, Japan is the first and only G10 country having fully implemented all pillars of the Basel II Capital Accord.[64]

Conclusions

This paper has traced the shifts in the governance of global banking supervision over the course of the negotiations on the Basel I and II Capital Accords. By also incorporating the developments in the structure of the banking sector of that period, it was first of all shown that there is a constant interplay between the shifts in governance and the developments in the market structure. To summarize in a nutshell: the internationalisation of the banking sector led to private sector concerns for unfair competition due to favourable supervisory models abroad, while the Latin American debt crisis alerted supervisors to the dangers of global financial integration. Both forces led to a global agreement on banking supervision, the first Basel Accord. The crude risk categories of Basel I gave banks an incentive to engage in

[61] It must be acknowledged, though, that consultation most likely was already standing practice of banking supervisors.
[62] Financial Times, July 15, 2004, p. 28. See Bieling & Jager for a critical perspective on the impact on the European economy.
[63] Financial Times, November 18, p. 19.
[64] Interviews with Japanese policymakers, November 2007.

securitisation, leading them to develop sophisticated risk models. At the same time, this confronted regulators with regulatory capital arbitrage. These developments again changed the governance preferences of the relevant actors, leading to the renegotiation of the Basel Accord. Hence, shifting patterns of governance change the constraints actors face in their actions in the global banking system, in turn leading to changing interests with respect to desired shifts in governance patterns.

Secondly, with the internationalisation of the banking sector and the policy-making process, a transnational policy-making community focussed on the BCBS emerged. This has led to the marginalisation of voices from outside the circle of expert financial policy-makers. With the further globalisation of the banking market, a new element in the implementation efforts of the BCBS is the institutionalised working group focussed on the implementation of the accord both in the G10 and in emerging markets. This likely will improve effective global implementation. The discussions in this transnational policy community draw on a limited range of arguments with a strong voice of the financial sector itself. It has led to a common outlook on the way forward: market-based governance mechanisms such as the IRB approach. Furthermore, the ties between supervisors and banks are further institutionalised in the Basel II Accord, since it calls for continuous dialogue between banks and supervisors. These elements have strengthened the private sectors voice in the policy-making process already over the period from Basel I to II, as well as for the future. As we have been witnessing the past 12 months, we can not only question the input legitimacy of this way of policy-making in financial governance, but also to a large extent its output legitimacy.

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