A cognitive mode of rule-finding in banking regulation
The Consultative Process of Basel II examined[*]
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ABSTRACT

This paper sheds light on the process of rule-finding in international banking regulation. From a systems-theoretical perspective and based on analyzed documents and interviews the consultative process of Basel II is examined. It is shown that this consultative process differs significantly from traditional forms of rule-finding, as it is oriented towards reciprocal learning. Thus, it is more about rule elaboration than rule setting. This *cognitive* mode of rule finding meets certain challenges of contemporary financial regulation as it is able to both deal with ignorance and provide acceptance. On the other hand, it becomes clear that such a mode of rule-finding is quite unlikely: First because a flexible time schedule is a decisive precondition (but often not given); second because it differs from a classical (normative) political logic, thus it is risky for politics to implement.

Keywords:- Governance, Cognitive Governance; Banking regulation, Basel II, Financial system

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I. Introduction: The prominence of rules and the relevance of rule-finding

How to regulate banks in an appropriate way? In the following of the subprime crisis this question is probably more prominent than ever before. Nevertheless every financial crisis in the last ten or fifteen years raised this same question.[1] Obviously, there is a correlation assumed between the content of regulatory rules (including institutional arrangements) and the financial systems stability. In consequence, it does not surprise that there is a vivid debate about in what fashion politics should govern banks to avoid crises and guarantee stability (e.g. Eatwell/Taylor 2000; Scholte 2002). On the other hand, this debate already indicates that in modern society politics cannot simply order stability. Instead, rules have to be found, which lead to stability. However, as these rules live a life on their own and, as the financial system follows its own logic it is often unclear which effects rules will take. This is especially true for the modern financial system, which is above all characterized by its complexity and lack of transparency. Moreover, according to its global operational logic the financial system has lost its coupling to nation-states (O´Brien 1992). As the subprime crisis recently demonstrated, a single event anywhere in the world can bring about a serious financial crisis of global extent. If this is true, the more fundamental question of *how to find* appropriate rules, gains in importance.

Given the ambiguity based on unknown cause-effect-relationships and the increased need for globally coordinated banking supervision international politics tries innovative and conditional forms of regulation. For about three decades the rules of banking regulation are no longer only be made on the nation-state scale. Especially the Basel Committee on Banking Supervision (BCBS)[2] is as an institution, which focuses on the development of banking regulations on the global level. Its latest framework on "International Convergence of Capital Measurement and Capital Standards" commonly known as Basel II was published in 2004. The involved actors describe Basel II as a *paradigm shift* (e.g. Deutsche Bundesbank 2001; FED Bulletin 2003) in banking supervision. This is mainly because of the qualitative elements in this framework – namely the Supervisory Review Process (SRP) in pillar 2[3] that seeks to

1 Particularly the 'Asian-Crisis' (1997/98) and the 'Russian-Crisis' (1998/99) have to be considered.

2 The BCBS was established in 1974 by the Group-of-ten-member states under the head of the Bank for International Settlements. Its goal is to secure safety and soundness of the global financial system. For the constitution of the BCBS and its function, see e.g. Wood 2005.

3 Comment: The details of Basel II are organized around a 3-pillar-structure. The first pillar aims at the capital requirements in view of credit risks and operational risks. The second pillar refers to the supervisory process. Additionally, the third pillar contains regulations of transparency and disclosure to 'the market'. So,

establish a dialogical mode of banking supervision. Up to now, banking supervision is above all organized around a quantitative approach, especially in Germany. That is to say that the fulfilment of rules is supervised by off-site-examinations. Based on periodical reports important financial ratios are scrutinized. The qualitative approach of Basel II in contrast strengthens on-site-examinations within banking organizations. This mode of supervision encourages a close cooperation between banks and supervisory agencies; so that (potential) processes of reciprocal learning may promote more soundness and safety of the global banking system as whole.

Unlike traditional (normative) forms of regulation, which used to be directive, Basel II sketches a mode of governance that is more oriented towards reciprocal learning and cooperation. According to a concept of Niklas Luhmann, this form of regulation can be named *cognitive governance*.[4] The SRP is a central element of this new (cognitive) mode of governance. It reflects the financial systems complexity within the phase of rule-application. These aspects are subject of a recurring debate and much attention has been drawn on the question what kind of rules offers which opportunities in the phase of rule-application.[5] This *prominence of rules* to a large extend obscured the *relevance of rule-finding*. Finally, the quality of rules will depend on the procedure of finding the rule – especially under conditions of complexity. Thus, this article wants to shed light on the mechanisms and consequences of rule-finding and focuses on the elaboration of the Basel-II-Rules as an example for a cognitive mode of rule-finding.

The elaboration of Basel II has mainly been based on an extensive process of consultation that took more than 5 years and differed fundamentally from former processes of rule-finding. The aim of this article is to work out the special characteristics of this consultative process and to examine in how far these features react to certain challenges. In doing so, the following chapter will discuss the special problems arising from the complexity and knowledge intensity of the financial system – particularly with regard to regulatory affairs. The third chapter will

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with Basel II a framework is available that takes not only the capital requirements into account but also describes the banking supervisory process and thus refers to both banks and supervision agencies.

4 The distinction between normative and cognitive modes of governance refers to a concept of Niklas Luhmann (1995: 321-325), who enhanced a former suggestion of Johan Galtung (1959). Luhmann distinguishes between two types of coping with disappointments of expectations: One can either insist on the expectation (normative style) or one can rearrange the expectation according to the disappointment (cognitive style) – one can learn.

5 See e.g. Goodhart/Schoenmaker 1995; Eatwell/Taylor 1998; Barth 2004; Barth/Caprio/Levine 2006. Especially for the case of cognitive governance, see Kette 2008 and Strulik 2008.

analyse the consultative process of Basel II and takes a closer look on the particular characteristics of this process. Referring to the problems outlined in the second chapter the forth chapter will ask for the capabilities resulting from such a consultative process. Thereby, a special focus will lie on the aspects of reciprocal learning and the acquisition of acceptance. A conclusion that discusses problems of a cognitive mode of rule-finding will complete this article.

II. The complexity of the global banking system: Regulatory challenges

The recent financial crisis as well as former crises demonstrates the necessity for a capable and effective package of rules to regulate the global financial system. Above all the growing complexity of the financial system and upcoming new forms of risks have made different, more adequate forms of risk regulation not only necessary but also conditional. Since the 1970s mainly three mutual reinforcing trends affect the complexity of the financial system: First, globalization – Starting with the breakdown of the Bretton-Woods-System an era of deregulation emerged, which eased the international flow of capital and thus promoted the globalization of finance. Furthermore, banks followed their key accounts abroad and became multinational enterprises. Second, digitalization – The invention of the microprocessor in 1971 marks the kick-off for the digital revolution. By and by it became possible to engage in financial transaction all over the world – in real time. This synchronization of the system time pushed on the globalization of finance. Third, knowledge intensity – The development of the Black-Scholes-Merton formula in 1973 led to a huge expansion of the derivative business as the prizing became much easier. In the following scientific techniques of calculation gained in importance for the creation of innovative financial instruments. This trend has been accompanied by the creation of scientific knowledge and organizational expertise to handle and manage new types of risk. Globalization, digitalisation and knowledge intensity still accelerate the innovation dynamic within the financial system and produce momentous interdependencies. They are the driving forces of the financial systems' complexity and the main reason for the increasing relevance of systemic risks.[6]

Under these conditions, the prospects for governing the financial system in a way that guarantees safety and soundness deem awkward. As cause/effect-relationships can hardly be under-

[6] Due to the interdependency within the financial system, those systemic risks endanger the system as a whole. Moreover, it is no longer possible to limit its effects on specific contexts. Both the emergence and development of such risks can hardly be forecasted. In consequence, it is not possible to elaborate emergency plans. For detailed analyses on systemic risks in the financial system, see above all Alexander/Dhumale/Eatwell 2006. See also Eatwell 2004.

stood it is probably not suitable to simply impose rules in a normative (directive) way. The circumstances are too complex to develop appropriate regulatory strategies without considering several perspectives. Therefore, the question of *how to elaborate* a regulatory framework is preliminary to questions about the rules' content itself.

Before the consultative process of Basel II is examined as one way of rule finding that refers to the outlined financial systems complexity, the main challenges for the elaboration of adequate rules have to be pointed out in more detail. The thesis is that the complexity and knowledge intensity on the one hand and the global operational logic of the financial system on the other hand brought about two major challenges: The first one refers to the relationship of knowledge and ignorance (in the sense of non-knowledge).[7] The second challenge stems from the fact that a legal-democratic form of legitimacy is not at hand on the global scale. Instead derivative forms of legitimacy have to be found and used for securing acceptance of globally coordinated regulations.

Private knowledge and regulatory ignorance in global banking

For a long time – especially in economics – the cooperation between regulators and regulated has been examined with emphasis on diverging interests and the relative maximization of utilities. Starting from this point of view it became obvious that a close cooperation evokes attempts of the regulated to affect the regulations according to their aims: The regulators are captured.[8] The accelerated innovation dynamic of the financial system in the last 15 years especially in the field of derivative financial instruments[9] and the related production of ever-new knowledge raise the question how the required knowledge can be made available in processes of rule-elaboration. As the private knowledge (e.g. of market participants) differs from the 'regulatory knowledge' the regulators are forced to incorporate private expertises in order to develop rules that can deal with the complexity of the financial system. Otherwise, the aim of a stable financial system would hardly be achievable. From this point of view a close cooperation between regulators and regulated appears as an opportunity for processes of

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7 For the increasing relevance of knowledge and ignorance in society, see Willke 2002. With special focus on the financial system, see Strulik 2004.

8 The most prominent discourse about the (adverse connoted) consequences the influence of the regulated would have on the quality of rules refers to the heading 'regulatory capture'. See e.g. Kane 1977; Kane 1988; Goodhart et al. 1998. Also with respect to questions of legitimacy a close cooperation between regulators and regulates is critical observed (see Underhill/Zhang 2006: 28ff.).

9 For the increasing significance of derivative financial instruments Heri 1994.

reciprocal learning and in consequence: for the working out of satisfactory rules.[10] To understand the significance of this argument it is necessary to do a step back and take a closer look on the relationship between knowledge and ignorance in global banking.

The debate about 'knowledge politics' and 'knowledge economy' (e.g. Stehr 1994; Strulik 2004; Willke 2002;) shows that economic transactions are not only based on knowledge in the sense that experience or the application of knowledge play an important role. Instead, all operations within knowledge economy underlie the problem of producing, managing and organizing ever-new knowledge. The innovation dynamic described above indicates that knowledge also occupies such a central position in the banking system. Thus, regulatory efforts concerning the banking system would need to cope with this knowledge intensity and – most important – with according ignorance.

Ignorance comes up as a correlate of any knowledge production. In this sense, it is always *undissolvable* ignorance. On a more abstract level, one has to distinguish between specific and unspecific ignorance. While specific ignorance means knowledge about what is not known, unspecific ignorance refers to the case that it is not known that and what is not known.[11] Especially with regard on regulatory affairs coping with ignorance – be it specific or unspecific – is an important challenge. Given the rapid innovation dynamic of the financial system and the ongoing production of new financial instruments, regulating agencies cannot keep pace with the changes within the financial system. In the end, this can be led back to knowledge problems. The US Department of the Treasury puts this aspect in its strategic plan as follows:

"The rapid increases in the volume of financial transactions, types of financial instruments, and a number of global players challenge the ability of the regulatory community to remain as modern as the market in its efforts to promote financial stability." (USTreasury 2006: 15)

This quotation refers to an important aspect of our further argumentation: The asymmetry of private and public knowledge. This asymmetry appears to be a problem for the regulation of the global banking system in two ways. On the one hand, this problem becomes crucial when rules are not flexible enough to incorporate new knowledge continuously. On the other hand, this problem even occurs in the phase of rule finding. In the light of lacking regulatory knowl-

[10] Torsten Strulik (2006) for example emphasises that reciprocal learning effects between private and public actors may lead to rules that are more adequate. For the analysis of the relationship of knowledge and power in the context of global governance, see Cutler/Haufler/Porter 2004 as well as Stone 2004.

[11] For the distinction between specific and unspecific ignorance see for the first time Merton 1987. Also instructive in this context: Japp 2000.

edge (and existing ignorance) the elaboration of satisfying rules becomes crucial. Of course, private actors also have their own *blind spot*. Philip Cerny describes the complexity of the financial system as follows:

> "The mathematical complexity of financial innovations and transactions has been running ahead not only of the ability of regulators to follow (much less to control a priori) but also the ability of many firms and financial firms to understand." (Cerny 1994: 331; highlights also in the original)

Therefore, the argument is not simply that regulatory agencies just have to get access to private knowledge. Instead, the question is how it may be possible to create *new* (regulatory and private) knowledge by specific forms of cooperation. Before we turn to the analysis of the consultative process to Basel II as an example for coping with this problem a second problem for governing the global banking system has to be discussed: the *global* operational logic of the financial system and its supra-national structure of interdependency.

Globalization, Legitimacy and generalized Acceptance

The breakdown of the Bretton-Woods-System in the early 1970s marks the starting point for an extensive liberalization of the financial system. In the following decades, nearly all nation-state boundaries became almost irrelevant for the operations of the global financial system. Additionally, the increased usage and capacities of digital data processing systems accelerated this tendency. In consequence the financial system attained an almost virtual quality as even commodity futures are to a great extent not fulfilled physically but rather virtually – just on the basis of data. Taken all these aspects of deterritorialization together it becomes clear that globalization poses a challenge for governing the financial system.

In the light of a globalized finance, all efforts to secure the safety of the financial system by regulations on a nation-state-level will fail. If it were intended to promote the stability of the financial system by (legal) regulation this would at least need *global* regulations. However, legal regulations on the global level are not easily to have. Because of the segmentary inner differentiation of the political system and the legal system (Luhmann 1998; 1993; King/Thornhill 2003) legitimate legislation and sanctioning are only possible within nation-states. Even if laws are imposed worldwide, the reach of each bill is restricted to the clearly defined scope of nation-state-territories. In consequence a legitimate legislation on the global scale would need a 'world-state' that can obviously not be found at present. Thus, a global regulation of the financial system can only be achieved indirectly via the (global) *coordination* of national legislations. Again, such supra-national coordination has still to cope with the problem of legitimacy. Only if it succeeds to find a substitution for the legitimacy deriving from the rule of law the chance for generalized acceptance will maintain. To put it in other words: A derivative form of legitimacy is a crucial precondition for the efficacy of globally coordinated legislation.

The emergence of the Basel Capital Accord of 1988 (Basel I) demonstrates that this point is far from being trivial. As Ethan B. Kapstein (1989) shows, the negotiations in the run-up of Basel I were very tough. For a while, it seemed as if it would not be possible to establish a global framework for banking regulation – mainly because of lacking acceptance and the doubt if one's own interests were represented adequately within the framework in question. Therefore, gaining acceptance for globally developed rules in one way or another is a very relevant issue. This point marks the second aspect that guides our further analysis of the consultative process to Basel II.

To summarize the discussed challenges for the governance of the global banking system it becomes clear that these are above all based in the fact dimension and the social dimension: With regard to the fact dimension coping with regulatory ignorance is the main problem in processes of rule elaborating. In the social dimension the problem of achieving acceptance has to be faced, as no formally legitimated authority is available that could impose rules in a top-down manner.[12] Before we can analyze in how far the consultative process of Basel II (as a procedure) reacts to these challenges, it is necessary to bear in mind what the main features of this process are. This will be done in the following chapter by describing the process of consultation.

12 Concerning the distinction of the fact, the temporal and the social dimension as three dimensions of meaning, see Luhmann 1995.

III. The consultative process of Basel II – a cognitive mode of rule finding

A short history about the formation of Basel II

On the supranational scale, attempts to coordinate the regulation of the global banking system come up with the constitution of the Basel Committee on Banking Supervision in 1974. Since 1975, the Committee has published several recommendations to achieve its aims of improving the quality of banking supervision worldwide. The most recognised publication was the Basel Capital Accord of 1988 (Basel I). Against the background of the Latin-American debt crisis in the early 1980s and the visible financial difficulties of international active banks, the BCBS-member states agreed to a minimum capital standard. This standard regulated how much equity capital banks would need in the future to secure their credit transactions. Moreover, it was intended to promote the robustness of the financial system.[13]

Shortly after it turned out that the little market sensible and inflexible regulations did not consider the dynamic character of the global financial system. On the one hand, the sharp increase of the knowledge intensive derivative business produced a regulatory need for action (Hoenig 1996). On the other hand, the banking organizations developed more and more highly skilled methods of risk management and calculation, which were much more efficient than the supervisory rules required. In the light of the obvious deficiencies of the then regulations and facing the increasing critics from banks and supranational associations the BCBS declared in September 1998 that Basel I will be revised. The aims of this reform process were formulated in the first consultative paper from 1999 as follows:

> "[...] the Accord should continue to promote safety and soundness in the financial system and, as such, the new framework should at least maintain the current overall level of capital in the system; the Accord should continue to enhance competitive equality; the Accord should constitute a more comprehensive approach to addressing risks; and the Accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication." (BCBS 1999)

A central presupposition for the decision to revise Basel I and the procedure of rule finding was the observed insufficiency of these regulations on part of both the political and the economic actors. In the early 1990s, the banking organizations as well as the supervisory agencies became aware that the given regulations are no longer adequate to keep pace with the

[13] For details about the emergence of Basel I and the long lasting negotiations in its run-up see Genschel/Plümper 1996 as well as Kapstein 1996.

accelerated dynamic and knowledge intensity of the financial system. It seemed important to intensify the inclusion of private actors in order to make use of their innovation competency and their appreciation of the problem. This was supposed to facilitate the arrangement of a new and more flexible supervisory approach (Strulik 2000: 220ff). While the elaboration of Basel I was mainly oriented at classical political proceedings (Kapstein 1989), with regard to the elaboration of Basel II the Basel Committee decided to include private actors and their expertise at a very early stage. In the forefront of Basel I on the contrary the credit services sector has only been included in a final, seven-month lasting (December 1987 to July 1988) consultative phase.

With the publication of the first, only basically formulated consultative paper in June 1999 the Basel Committee initiated an intensive dialogue between the credit services sector, national supervision agencies and the committee itself. Furthermore, comments from all interested parts were permitted.[14] The phase for comments was set until March 2000. For the course of the year 2000, it was planned to publish a second, more concrete consultative paper – based on the comments to the first one. Up to this time the schedule did not set any deadline for the final passing of the revised international capital framework (BCBS 1999). On the basis of more than 200 received comments the Basel Committee published a second consultative paper in January 2001 (BCBS 2001b). Until the end of the related consultative period in May 2001 the Basel Committee for Banking Supervision received over 250 comments and statements (BCBS 2001c). Because of the huge number of comments and their diverging content, it became clear that an immense need for coordination subsisted further on. In consequence, the Basel Committee postponed the passing of Basel II – which was planed for July 2001. Instead, the Committee decided to realize a third consultative phase. This was intended to start at the beginning of 2002. The beginning of the implementation phase of Basel II was scheduled for the end of the year 2005. Due to the results of a parallel run impact study (QIS 3)[15] the release of the third consultative paper has been deferred until April 2003. In consequence, the start date for the implementation of Basel II has been delayed again –on the End of 2006. Based on more than 200 comments (BCBS 2003) to this third consultative paper most recent amendments were made. On June 26th 2004, the final version of Basel II has been passed under the title "International Convergence of Capital Measurement and Capital Stan-

[14] For instance, one can find comments by scientists, politicians, accountants, industrial companies as well as statements from supervision agencies and banks of non-BCBS-member-states.

[15] Accompanying the consultative process so-called Quantitative Impact Studies were run in order to estimate the consequences of foreseen changes (BCBS 2001a). The latest impact study (QIS 5) has been undertaken from October to December 2005 (BCBS 2005).

dards – A Revised Framework”. Based on this foundation, the national laws have been worked out, which build the legal frame for the application of Basel II. Within this phase, certain national adaptions and concretions were possible.[16]

1999	2000	2001	2002	2003	2004	Still ongoing
June 3rd: first consultative paper (cp) is published - *ipd*: none* *iid.: none*		**January 16th:** second consultative paper is published - *ipd: end 2001* *iid: 2004*	*Based on the responses to the second cp the BCBS intended to publish cp3 in early 2002 and to finalise Basel II during 2002*	**April 29th**: third consultative paper is published - *ipd: end 2003* *iid: end 2006*	**June 26th**: Passing of Basel II *iid: end 2006 resp. end 2007*	*Since 2007 the implementation of Basel II has started. Details depend on the advancement of the risk approach. Still the implementation has not been finished yet in all member-states.*[17]
up to March 31st 2000 consultation phase to the first consultative paper		**till May 31** Consultative phase to the second cp.		**till July 31** Consultative phase to the third cp.		
***CAPTION:** ipd: Intended passing date (of Basel II); iid: Intended implementation date*		During the whole period of consultation, the work of the BCBS was also enriched by the evaluation of quantitative impact studies (QIS). Especially the results of QIS 3 are responsible for the delay of cp3.				

Table 1: the road (and turnings) to Basel II

These elucidations display the differences between the extensive consultative process in the course of Basel II and the rather rudimentary inclusion of the banking industry that convoyed the elaboration process of Basel I. This shift is also reflected in the assessments of involved actors. A staff member of the Basel Committee for instance qualifies the forms of rule finding practiced before Basel II as “closed shop” (Interview 050816). The remarks of a leading representative of the German “Bundesbank” regarding the new quality of the Basel II-consultative-process explain this assessment:

„Wir hatten, ich muss das jetzt vielleicht einfach kurz sagen, weil das in Basel II schon neu ist, in der Vergangenheit häufig den Fall, dass die Aufseher hinter verschlossenen Türen getagt haben, und wenn sie dann etwas fertig hatten, ist es zur Konsultation mit der Kreditwirtschaft gestellt worden. Die haben dann ein paar Wochen oder Monate Zeit gehabt, sich zu äußern und dann war es irgendwie durch. Dann hat die Aufsicht noch mal nachgedacht, das ein bisschen reflektiert und dann war es in der Welt. Das heißt, es hat auf der

16 On the EU-level parallel to the negotiations in Basel a consultative process on its own took place. This sought to elaborate – based on the Basel recommendations – an EU Directive.

17 Additionally the Basel Committee still publishes enhancements to the Basel-II framework (BCBS 2009).

internationalen Ebene schon mal gar nicht, aber auch national eigentlich nie so ein Dialog begleitend zu einem Regelwerk stattgefunden, wie das in Basel II der Fall gewesen ist." (Interview 050222)[18]

This quotation already indicates some characteristics that distinguish the consultative process of Basel II from former procedures of rule finding. Essentially these innovations – which capabilities will be examined below – are founded in the social and the temporal dimension. With regard to the social dimension, one can see that the extensive inclusion of principally all affected actors – especially the banking industry – goes far beyond the well-established methods of rule finding. Taking additionally the temporal dimension into account, the innovative aspects become much clearer. Firstly, it is striking that the banking industry has been included *since the start* of the rule-finding process. The elaboration of Basel I has been mainly a matter of negotiations between nation-states and the banking industry has only been involved in a *final* period of consultation. In contrast, the consultative process of Basel II is about the continuously public-private dialogue attending the whole process.

Thereby the particular way of incorporating the regulated is of special relevance. Insofar every single consultative paper considers the responses of the preceding paper and is itself posed to be commented, productive recursion loops can be identified. This does not only apply for the relationship of political and economic actors but also for the phases of problem definition and solution exploration. Hence, the consultative process establishes social and factual recursivity. With emphasis on iterative aspects, these recursion loops can be described as institutionalized mechanisms, which enable opportunities for collective learning. In consequence, the recursivity of the consultative process also explains the size and the complexity of the revised framework.[19] A staff member of a German banking association pictures this gradual extension of Basel II during the consultative process very descriptively:

„Ich vergleiche das gerne mit einem Hausbau. Wir haben angefangen mit einer relativ sparsamen Hütte, die Ihren Bedürfnissen entgegenkommt. Und mittlerweile hat man da eine ziemlich verwinkelte Burg draus gemacht. [...] Das war kein Selbstzweck und es war auch keine Böswilligkeit von irgendwelchen Beteiligten. Sondern, das war einfach dem Umstand geschuldet, dass dieses Thema so tief eingreift in ganz essentielle Bereiche des Kreditgewerbes, und der Kreis derer die daran beteiligt war so groß geworden ist, dass das

[18] „In the past – I have to say this because this is new in Basel II – it has often been the case that supervisors met behind closed doors. Moreover, as they had finished something it has been given to the banking industry for consultation. They were given a couple of weeks or months to react and than it had been passed in some way. Than the supervisors reflected the reactions a bit and finally it has been in force. That is to say, that it has never before – on the international level least of all – but even on the national scale such a dialogue existed, accompanying a framework like it was the case in Basel II." (Own translation)

[19] While the first consultative paper of 1999 just contained 62 pages, the 2004 passed framework contains 251 pages.

Bedürfnis nach einem Kompromiss es erforderlich machte, dieses Regelwerk eben so komplex und so verästelt [...] auszugestalten.“ (Interview 050413)[20]

A second important issue illustrating the innovative quality of the Basel II consultative process concerns the resilience of the schedule. Niklas Luhmann often alluded to the impacts that dates and time limits have on the quality of decisions (Luhmann 2000; 1981; 1971). Often decision maker give keeping to the dates top priority and so suppress factual issues. Looking at the genesis of Basel II, one can see that at the outset not any implementation date was stated. Moreover, in the later on it has been delayed repeatedly. These delays are the result of the evaluation of both the above-mentioned Quantitative Impact Studies and the numerous comments and statements.

Achievements of the consultative process of Basel II

To analyse the capabilities of a cognitive oriented mode of rule finding it is necessary to bring together the regulatory challenges described in chapter II and the examined characteristics of chapter III. The problems identified above are 1) to secure acceptance and 2) to cope with ignorance. The problem of securing acceptance grounds in developments described by the term globalization; the second problem of coping with ignorance regards an upcoming knowledge society. Even if the Basel Committee has already been focused the issue of globalization since the 1970s[21] the problem of a lacking legitimate authority on the global scale still produces challenges for securing acceptance. Hence, it is indicated to examine the consultative process under this point of view. The explicit appreciation of ‘knowledge problems’ has only come up in the last few years. Obviously, processes that include all relevant actors and their specific knowledge gain in importance. With regard to the emergence of Basel II, on an abstract level it becomes clear that the introduction of an *‘if/how’-distinction* reacts to both problems. While the decision that a reform is needed has been made within the Basel Committee, the definition of contents has been left very open. No more than in the context of the consultative process the question of how to design Basel II has been negotiated. Compared to the

[20] “I like to compare this with building a house. We started with a relatively parsimonious hut that fulfils your demands. In the meantime, it has become a castle full of nooks and crannies. [...] That has not been an end in itself or malevolence of any involved actors. It was just due to the fact that this issue affects essential parts of the credit business and that the group of participants grew in a way that the need for a consensus made it necessary to sharpen this framework such complex.” (Own translation)

[21] The globalization of the financial system was one of the first issues the BCBS has faced. Already the both *Concordats* from 1975 resp. 1983 are efforts to coordinate *inter*national banking supervision in the light of a more and more global operating financial system.

genesis of Basel I this cognitive openness mark the essential innovation of the consultative process of Basel II.

A dialogical and cognitive oriented mode of rule finding, as it was applied during the consultative process of Basel II seems to react to problems of acceptance in two ways: On the one hand, the broad dialogue not only between the BCBS-member-states but also between non-member-states compensated the absence of a supranational legislation authority. The extensive participation of all relevant nation-states within the process of rule finding improved the prospects for a later conversion into national law.[22] On the other hand, the active inclusion of all interested parties met certain problems of input legitimacy (cf. Underhill/Zhang 2006), as it gave private actors the opportunity to influence the content of the new framework. This is especially true with regard on the consultation of the banking industry in the process of rule finding. Therefore, the far-reaching exchange of ideas promotes a generalized form of acceptance on the level of nation-states as well as on the level of the regulated. On the one hand, such recourse on the expertise of the regulated raises questions of legitimacy (in terms of independent regulatory agencies). On the other hand, the problem of an uncontrollable regulatory dialectic seems to decrease: By elaborating supervisory rules and instruments through a dialogical and learning oriented form of cooperation, the supervisory agencies and the banking organizations can better assess the outcomes of their always-risky innovation decisions. Thus, the cooperation between regulators and regulated may mainly increase the output legitimacy. Obviously, the enlarged complexity of the financial system enforces cognitive procedures, which gain legitimacy out of a temporal public-private consensus about a store of knowledge that is defined as valid (Willke 2002: 194). This point already indicates that the consultative process of Basel II also reacts to the problem of ignorance.

Up to now, it has been shown that the recursivity of the consultation process both reacts to problems of acceptance and creates opportunities to combine different kinds of expertise regarding the exposure to deal with financial risks. Exactly therein lays the intelligence of the consultative process of Basel II. Asking for the conditions of possibility of such capabilities it becomes clear that this function has to be classified within the time dimension. The indeterminate implementation date – and related temporal resilience – is the basic requirement for establishing efficient recursion loops. Taken together, the mixture of two contrary principles

[22] Furthermore, the indeterminate formulation of Basel II offers possibilities for adjustments to national conditions during the phase of implementation.

explains the capability of the consultative process. The normative adherence to the decision *that* Basel I will be revised in combination with the cognitively openness about *when* it will be implemented, appear to be important preconditions 1) for the sufficient treatment of conflicts and 2) for securing an issue-related debate during the whole process.

„Sehr wichtig in Basel war, dass man jetzt nicht nur politisch argumentiert, sondern Forderungen jetzt auch durch wissenschaftliche und empirische Studien unterlegt. Das ist jetzt vielleicht eine Veränderung im Vergleich zu früheren Prozessen, dass jetzt also viel stärker wissenschaftlich argumentiert wird, dass man also wirklich auch mit Hilfe von empirischen und theoretischen Studien eine möglichst fundierte Regelungen finden möchte." (Interview 050222b)[23]

According to this knowledge orientation within the consultative process, even the above-mentioned impact studies can be understood. The impact studies also take time – a fact that only appears acceptable if the schedule is flexible enough. In sum, one can see: The capability of cognitive, learning oriented, consultative processes in regulatory fields depends to a large extend on the possibility to bring the content-oriented expectations in a *cognitive* mode by insisting on the reform decision in a *normative* way at the same time. As a result, it renders possible to generate sufficient recursivity. The decisive foundation for those efforts is the available temporal capacity.

While some political scientists may argue, that the described delays are due to contradicting interests of the engaged parties, this analysis draws another picture. The establishment of a process that is oriented towards the incorporation of available knowledge functions as a guiding mechanism in the course of the elaboration process. If preconditions are complied with, knowledge can and does work as an independent *medium of guidance*. Just like power (or money), even knowledge is capable of enabling and constraining certain follow-up communications (Willke 2007: 29-33). That is the point, why the results of an elaboration procedure like the consultative process of Basel II differs fundamentally from traditional forms of political bargaining. In consequence "even the USA, which have for sure a very strong bargaining position, had to make big concessions" (Interview 050413 / own translation).

[23] „It has been very important in Basel that it has not only been argued in political categories. Rather claims were underpinned by scientific and empirical studies. That may be a difference to former processes: That the argumentation is much more scientific and that one really tries to find sufficient rules by the use of empirical and theoretical studies." (Own translation)

IV. Summary and Conclusions

This article started with the observation that finding innovative rules for the governance of the global and knowledge intensive financial system is a crucial issue. Given the complexity of the financial system, the process of rule finding itself challenges the regulatory community. Hence, efficient governance first has to find an adequate mode of elaborating rules. The possibilities for finding adequate rules depend on the chosen way of rule finding. To put in other words: The content of rules depends on the processes that framed its emergence. This observation was reason enough to take a closer look on the characteristics and capabilities of the consultative process of Basel II. This analysis has been guided by the identified challenges for the governance of the banking system. Namely 1) the problem of securing acceptance in view of a lacking legitimate global authority and 2) the problem of coping with ignorance.

The characterization of the consultative process has shown, that in general one can depict this process as cognitive oriented. In contrast to normative oriented procedures that bring new rules into being by directive forms of *rule setting*, the consultative process is characterised by a dialogical and learning oriented mode of *rule elaboration*. The extensive involvement of private actors beginning at a very early stage is the key feature of this process. Moreover, the flexible time schedule is characteristic for the consultative process and allowed continually amendments of the rules during the whole process of elaboration.

Both aspects the learning orientation and the flexible schedule reacted in different ways to the problems of coping with ignorance and securing acceptance. The flexible time schedule provides the basis for an issue-oriented debate that in turn is the precondition for establishing processes of reciprocal learning. Additionally, the broad inclusion of all kind of interested actors also secured both the banking industry's acceptance as well as the acceptance of the involved nation-states.

Taken all aspects together it turns out that a cognitive oriented mode of rule finding is more likely to prepare for the challenges coming up with a globalized and knowledge intensive field of regulation. This does not mean the quitclaim of all normative expectations. Rather the capability of a cognitive mode of rule finding lies in the mixture of normative and cognitive expectations. Thus, it is still important to stabilize the expectation that a new rule is required in a normative way. Otherwise, the danger would be very great that the reform would fizzle out. At the same time the readiness to admit other opinions, to reflect them and to change own expectations is necessary and elementary for a learning oriented – a cognitive – mode of rule finding, that seeks to meet the financial system’s complexity.

This proportion of mixture can be found in the consultative process of Basel II. However, as the underlying mechanism, which accounts for the capabilities of this procedure is not exclusively related to the financial system it seems transferable to other regulatory contexts. Of course, this procedure may be adapted to special conditions and circumstances in each field but the underlying mechanism of a shift towards more cognitive openness may also be useful in fields like biomedical sciences, genetics, climate protection or pandemia prevention. All these listed areas are characterized by global scope and an ongoing huge production of knowledge and ignorance – the same challenges the regulation of the financial system has faced.

This analysis has worked out some promising effects of a cognitive mode of rule finding. Nevertheless, the development of such processes is quite unlikely. The knowledge orientation differs too far from the logic of political power. Again, the recent experiences in the following of the subprime crisis teach, that under stress politics will shift to a normative style of governance. At least this will shrink decision time and thus increase the politics’ capability to act – whatever it will bring about.

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