

Is Basel III Enough?

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Introduction

What started as a subprime housing bubble in the summer of 2007 became the most severe financial crisis since the Great Depression, and lasted until mid-March of 2009.¹ The collapse of the Lehman Brothers, caused by its having just US\$25 billion of capital to finance US\$700 billion, triggered a financial panic that spread rapidly and globally.² However, the negative effects of this crisis have not damaged just the financial sector. In fact, its negative outcomes have spilled over from the financial system into the real economy. As the origins of this crisis are deeply related to the financial system, the international regulation of financial markets has been the focus of concerns regarding its inability to properly regulate such markets in order to prevent financial crises, and the need to incorporate new rules and regulations to minimize the impacts of financial shocks.

The regulation of the international financial system is a perfect example of the sort of global challenges faced nowadays. These require an orchestrated effort to harmonize policy across different states. In order to deal with these challenges, governments have developed international networks of officials who work together in transgovernmental networks. The Basel Committee on Banking Supervision (BCBS) is an example of a transnational network that seeks to improve collaboration among agencies that oversee and regulate banks. BCBS' prime goal is to define international standards based on which banks should be regulated. In terms of global financial regulation, BCBS is vital to the governance of the international financial system because of its importance as an international standard-setting institution. It was established in 1974 precisely to tackle the emergence of several international financial issues that could not be properly dealt with at the national level alone.

¹ BIS, BIS 79th Annual Report, 2009 <http://www.bis.org/publ/arpdf/ar2009e2.pdf>

² Paul Collazos, "The Big Financial Crisis", in Francesco Cannata and Mario Quagliariello (eds), *Basel III and Beyond: A Guide to Banking Regulation After the Crisis*, Risk Books, 2011, p.27-8

BCBS advances its standards through its accords, which are known as the Basel agreements – currently under the third version. Although the Basel accords have a voluntary nature as they are not legally binding, states have strong incentives to implement them. Because markets and international financial institutions adopt the Basel agreements as a reference, they perceive the lack of implementation of such accords as undesirable, which ultimately is detrimental to a state's financial system. Therefore, BCBS is seen today as the leading international financial standard-setting body in the world. Despite the fact that BCBS's resolutions have extensive consequences throughout the world, it has a limited secretariat, and most of its staff is on temporary secondment from other regulatory agencies.

A failing bank has the potential to increase systemic risk, which is the widespread perception that the financial system as a whole could collapse, throughout the economy. This in turn could be detrimental to the stability of the financial system. Thus, bank failures are deeply related to the social costs associated with financial instability. The Basel agreements rely heavily on capital requirements, which are part of a capital-based approach to banking supervision, in an attempt to make the international financial system less prone to financial crises. Basel I was the first agreement to include specific requirements of capital to internationally active banks. The rationale is that capital requirements offer a safeguard to banks and other financial institutions so that during periods of stress – financial shocks, for instance – they have greater chance to navigate a severe crisis as they could function without the imminent risk of insolvency. Despite being the chief form of prudential regulation over the past 25 years, the benefits and costs of capital requirements are still debatable. Moreover, setting adequate levels of capital requirements are highly desirable to the safety of the financial system, as well as the healthy growth of the world economy. Otherwise, as banks play a pivotal role in the world economy, higher than

necessary capital requirements would lead to less lending, which in turn means more difficulties to, for instance, businesses to expand their factories and hire more workers. Less money available, therefore, would be harmful to the world economy's recovery. Too low capital requirements, on the other hand, would promote a less stable financial system that could be more susceptible to crises, as witnessed before the global financial crisis.

Even though by 2008 the second Basel agreement was still being implemented, it is seen today as flawed. Hence, there is a necessity to adopt another agreement with more stringent regulation to supplement Basel II. Basel III is the attempt to increase the resilience of the banking system, tackle the causes of the current financial crisis and thus prevent future crises from happening – at least in terms of their severity.

While the negotiations regarding Basel III implementation are still ongoing, earlier pledges by policymakers and regulators at the onset of the global financial crisis have not been met. There was a change in attitude regarding banking regulation and suddenly policymakers perceived that the market itself may have the ability to correct inadequate behaviour of financial institutions. As of October 2007, the BCBS was still encouraging the adoption of Basel II as the best remedy to the crisis. However, as the crisis strengthened, BCBS announced measures to strengthen the resilience of the banking industry. Such measures are today regarded as the minimal possible as a means to be seen as a responsive institution to the crisis at hand. Later, on December 2009, the BCBS, pressured by policymakers particularly from the G20, released a set rules regarded as excessively harsh by the financial industry, which was shocked by such package. On July 2010, a compromise was reached between regulators and bankers that imposed less stringent regulation on capital requirements. So far, the third Basel agreement has had eight consultative papers, five sets of principles, two impact studies and a number of guidance papers.

Although Basel III is seen as a better regulatory framework if compared to Basel II, it is also perceived as inadequate to prevent future crises. In fact, the amount of capital requirements required is below half of what financial economists now recommend as the optimal capital requirements. Thus, focusing the analysis solely on capital requirements under Basel III, it is plausible to argue that, although it is a step in the right direction, there has only been a partial improvement if compared to Basel II.

The compromise aforementioned was a victory for the financial industry lobby as two ratios were removed from Basel III. This, however, is not a unique feature of the third agreement. In fact, the second Basel accord was also amended to dilute part of the regulation initially included. The Institute of International Finance (IIF) represents the financial industry globally, and lobbies regulators, policymakers and politicians. This financial association aims at shaping regulatory, financial, and economic policy issues of relevance to its members. The nature of financial regulation, which is characterized as highly technical, grants the IIF an expert authority that allows it to participate actively in the debates held in Basel and advance its opinions effectively.

As a well-funded institution, the IIF is able to generate knowledge through research and studies, even if questionable, to advance its goals. When disinterested studies are published, the damage caused by IIF's studies has already been done. The release of these studies help the IIF portray tighten financial regulation as detrimental to the recovery of the world economy regardless of them being highly exaggerated. Hence, politicians' concerns about the impact of banking regulation on the real economy are not separated from this industry's pressure, whose tactics include lobbying and the release of questionable studies, along with pressure on politicians as means to advance its ends.

If, through the regulatory process, the regulated industry unduly promotes its interests, this phenomenon is known as regulatory capture. There are several determinants of regulatory capture that highlight the complexities associated with it. If the BCBS has really been captured by the financial industry, the analysis of these determinants should provide a better understanding of it. Moreover, the careful consideration of policies aimed at preventing such problem from persevering must be considered.

Throughout this brief description of the main topics that will be closely examined in this paper, it is clear that it touches on several complex issues that still puzzle social scientists. When examining the behaviour of policymakers and regulators, their lack of consistency regarding their promises is noteworthy. Due to the most recent financial crisis, also known as the Great Recession, the banking industry has been particularly scrutinized by international financial institutions in an effort to increase the resilience of the sector. BCBS's main objectives are to enhance the understanding of key supervisory issues and to improve the quality of banking supervision worldwide. It plays a pivotal role on these efforts as it is responsible for the development of the Basel accords. In essence, BCBS sets standards on cross-border and effective banking supervision, and on capital adequacy.

In light of the multidimensional relationship between regulators, bankers, and governments, this paper strives to explain why Basel III is not as robust as it was originally intended or expected to be. In order to achieve this goal, it is structured as follows:

- Section 2 – “The BCBS and its importance as an international standard-setting body”, which gives a brief overview of this organization and its relevance as a transgovernmental network. The subsection 2.1 – “The Basel Accords and Capital Requirements” highlights the relationship between these agreements and capital

requirements. In addition, it emphasizes the controversy surrounding the benefits and costs associated with these requirements;

- Section 3 – “From Basel II to Basel III: a limited evolution” describes the main shortcomings identified at Basel II. Further, it analyses Basel III’s deficiencies and how it is a timid response to the financial crisis. Finally, it considers experts’ recommendations regarding optimal capital requirements.
- Section 4 – “Bank lobby and Basel III” looks at the financial sector lobbying practices, particularly through the IIF, and emphasizes the importance of the phenomenon of regulatory capture. In addition, a thorough analysis of the determinants of regulatory capture is necessary to assess whether or not the BCBS has been captured by the very industry it is supposed to regulate. In order to do so, the nature of stakeholders’ participation in the regulatory process, the institutional design, the ability to capture regulators based on similar ideas, beliefs and mind-sets, and the possibility of capture through the political process will be evaluated both in terms of financial regulatory agencies in general and BCBS in particular. The subsection 4.1 – “Policy agenda to mitigate regulatory capture at the international level” assesses a set of policies designed to address these issues.
- A Conclusion summarizes the main findings and reinforces the most important observations.

Section 2 – The BCBS and its importance as an international standard-setting body

Global challenges require coordinated efforts to ideally harmonize policy across different jurisdictions. Transgovernmental networks have been used to achieve this goal as they incentivize government officials to work together in a coordinated fashion. Generally, governments connect their public servants and their counterparts abroad to build a network. There are important advantages and disadvantages regarding this model. Two relevant advantages are: The informality aspect that some transgovernmental networks have allows them to accommodate different preferences and respond swiftly to policy challenges as they have lower transaction costs, which occurs when undertaking an economic exchange, and “considers the relative merits of conducting transactions within firms and between different firms using markets.”³ Also, issues that demand technical expertise tend to be handled more efficiently if specialized participants work together, rather than diplomats with general knowledge. When it comes to the disadvantages, these networks are less likely to encourage credible commitments among states to enforce them because they are not formally binding – even if states sign the agreement they still have to implement it through domestic legislation in order to become law. Moreover, networks’ flexibility may be an obstacle to promoting binding agreements among signatories in the sense that these networks are perceived as so malleable that they may not command the same seriousness that a formal governmental agency would.

The BCBS is a perfect example of a transgovernmental network that intends to promote “cooperation between agencies that supervise and regulate banks.”⁴ Its main objective is to set international standards by which banks should be regulated. It is commonly referred to as a

³ A Dictionary of Economics. John Black, Nigar Hashimzade, and Gareth Myles. Oxford University Press, 2009. Oxford Reference Online. Oxford University Press. University of Ottawa. 20 July 2012

⁴ Kevin Young, “The Basel Committee on Banking Supervision”, in Thomas Hale and David Held, eds, *Handbook of Transnational Governance*, Polity, 2011, p.39.

typical transnational technical body that sets “the pace of financial regulation, and is considered central to the system of global financial governance.”⁵ The BCBS was established in 1974 as an informal group inside the Bank for International Settlements (BIS). At that time, it was clear that “the re-emergence of global finance was causing governance dilemmas which could not be addressed at the national level alone.”⁶ Thus, its main purpose was to be a response “to turbulence in the international currency markets following the breakdown of the Bretton Woods system in the early 1970s”.⁷

BCBS’ first major framework was called the Basel Concordat of 1975 and it dealt with the supervision of internationally active banks by setting an “international division of labour between regulatory authorities”.⁸ Moreover, the BCBS was originally designed to be a very selective group of financial regulators and central banks of the ten most advanced economies (G10), which was established in 1962 to participate in the General Arrangements to Borrow (GAB). Nevertheless, in 2009 BCBS expanded its membership to the G20 countries due to the recent global financial crisis and as requested by the G20 in November 2008.

The BCBS does not have any legal supranational authority to impose its agreements (no legal force). In addition, BCBS’s members are not formally delegated to make decisions on behalf of national governments. The agreements developed within the BCBS are not subject to approval by any external authority, national governments included. Most of the decision-making process is based on technical arguments, and discussions tend to be informal, while decisions are

⁵ Kevin Young, “The Basel Committee on Banking Supervision”, in Thomas Hale and David Held, (eds), *Handbook of Transnational Governance*, Polity, 2011, p.39.

⁶ Ibid

⁷ Jakob Vestergaard and Martin Hojland, “The New Standard in Banking Regulation: From Basel II to Basel III”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.51

⁸ Kevin Young, “The Basel Committee on Banking Supervision”, in Thomas Hale and David Held, (eds), *Handbook of Transnational Governance*, Polity, 2011, p.40.

mainly achieved via consensus.⁹ The decisions made by the BCBS officially apply only to member countries, which usually have to be ratified by their national governments. Thus, in that sense, they have a voluntary nature.

Despite not being required to submit its decisions to the approval of any national governments, BCBS's participants are not elected representatives. Indeed, they are not even officially delegated to act on behalf of states. Instead, participants are senior bureaucrats within regulatory agencies and central banks that act independently, based on technical discussions, mostly informal in character that seek to achieve consensus decisions.¹⁰

Yet there are strong incentives for countries that are not BCBS's members to implement the Basel agreements. Because the international financial system is vastly interconnected today, if a country decides not to abide by BCBS's standards, markets would see it as a sign of "weakness", and would perceive it as a less safe place to invest. Hence, the great majority of countries choose to implement Basel accords. In fact, the Basel I accord was adopted by over 120 countries by 1998.¹¹ Moreover, states are encouraged to adopt the regulations advanced by the Basel agreements as they are widely used as a reference. For instance, international capital markets use Basel standards to assess the financial reliability of banks as well as international financial institutions, such as the IMF, evaluate banks and banking systems based on the metrics promoted by the Basel accords.¹²

⁹ Slaughter Anne-Marie, *A New World Order*, Princeton University Press, 2005, p.160

¹⁰ Kevin Young, "The Basel Committee on Banking Supervision", in Thomas Hale and David Held, (eds), *Handbook of Transnational Governance, Polity*, 2011, p.27

¹¹ Ibid, p.29

¹² Ibid. p.27

Additionally, BCBS has a global influence on how financial regulation is conducted. It is known as “the lingua franca of capital”¹³ because it affects “the daily practices of risk management, and is integrated into the culture of firms.”¹⁴ Although the Basel accords are not legally binding, its rules are implemented and enforced “but not through legal, sovereign authority”, being “a prime example of soft law”.¹⁵ BCBS is clearly a global regulation forum, which is generally characterized as an exercise of ‘soft law’, as opposed to ‘hard law’ at the national level. Also, ‘soft law’ is frequently developed by either public-private or solely private networks “to which no rule-making authority has been delegated.”¹⁶ Thus, it has low levels of ‘obligation’. However, if a state decides not to abide by global financial standard, it may be subject to several harsh consequences, such as “capital flight, loss of competitiveness, and a crisis of confidence.”¹⁷

Even though BCBS’s decisions are far-reaching and their primary goal is to “enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide”¹⁸, its secretariat is fairly small. Most of its staff is on a temporary secondment from the regulatory agencies that constitute the BCBS.

Although the BCBS has worked as a secretive informal group for most of its history, it has intensified its engagement with external players through consultative procedures. Another form of external arrangement has been through technical consultative papers that are open for public comment. Yet this remains chiefly dominated by private sector involvement.

¹³ Kevin Young, “The Basel Committee on Banking Supervision”, in Thomas Hale and David Held, (eds), *Handbook of Transnational Governance*, Polity, 2011, p.27

¹⁴ Ibid

¹⁵ Ibid, p.39

¹⁶ Walter Mattli and Ngaire Woods (eds), *The Politics of Global Regulation*, Princeton University Press, 2009, p.3

¹⁷ David Andrew Singer, *Regulating Capital: Setting Standards for the International Financial System*, Cornell University Press, 2007, p.10

¹⁸ Kevin Young, “The Basel Committee on Banking Supervision”, in Thomas Hale and David Held, (eds), *Handbook of Transnational Governance*, Polity, 2011, p.39

To sum up, firstly BCBS's standards have been used by international capital markets as a means to assess the safety of banks. Second, international financial institutions, such as the IMF, have adopted Basel's rules as an essential metric. Hence, the BCBS has been regarded today as the most influential international financial standard-setting body in the world as states have significant reasons to emulate BCBS's standards.¹⁹ This institution's governance is seen, however, as highly complex and multifaceted, and social scientists have had particular interest due to its atypical structure, particularly its institutional context which means that its decisions are "several steps removed from sovereign authority".²⁰ While there have been attempts to increase external participation, particularly of diverse stakeholders, at BCBS's decision-making processes, these are still mainly controlled by participants in the private sector.

Section 2.1 – The Basel Accords and Capital Requirements

Firms in general, not only banks, are potentially making less money when they have to put aside an amount of capital known as capital requirement. In the case of banks this assertion seems to be even more appropriate as their profits come heavily from lending money to borrowers. In other words, capital set aside is perceived by some experts as expensive once it entails foregone profits "that could otherwise have been made from deploying that capital actively."²¹ In the case of the banking industry, however, the propensity to have market-induced capital reserves tends to be insufficient for two reasons.²² As the great majority of depositors have insurance, which protects them against bank failures, they have no incentive to observe capital adequacy practices of their banks attentively. On the other side, the gradual institutionalization of government

¹⁹ Kevin Young, "The Basel Committee on Banking Supervision", in Thomas Hale and David Held, (eds), *Handbook of Transnational Governance*, Polity, 2011, p.26-7

²⁰ Ibid, p.27

²¹ Jakob Vestergaard and Martin Hojland, "The New Standard in Banking Regulation: From Basel II to Basel III", in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.52

²² Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation*, Peterson Institute for International Economics, 2008.

bailouts encourages banks not to maintain adequate capital buffers, which in turn enhances the severity of a principle known as moral hazard. Banks have been bailed out by governments as far back as the Great Depression.²³ Hence, depositors have several forms of insurance that lead them not to worry about credit worthiness, and large banks have incentives to pursue higher risks and profits because they can implicitly rely on governments to bail them out should it be necessary. Capital requirements were the needed regulatory reaction to this problem, which broadly ruled that banks should put aside a pre-determined amount of capital in case of financial crises or unexpected losses as to guarantee their solvency in such scenarios. Thus, these requirements offer a cushion that would allow banks to operate without an imminent risk of insolvency. Increased international financial interconnectedness have meant that national regulations are not sufficient to regulate internationally active banks, which could pose a threat to the stability of foreign jurisdictions as well as to their home country.

As a means to tackle these challenges, Paul Volcker, former chairman of the US Federal Reserve, advanced “a common framework for capital regulation of internationally active banks.”²⁴ Although at first this idea was regarded as unfeasible due to the variety of national financial systems in place at the time and the fact that it was perceived as interference on national sovereignty, Mr. Volcker first managed to persuade his counterpart at the Bank of England and, as a result, he eventually succeeded in getting the approval of the G10. Thus, the 1988 Basel I agreement was the first to implement standards for capital requirements of international banks. Basel I was developed to promote two main goals, namely to create a level playing field for international banks, and to advance a stable international banking system. These

²³ G.A. Holten, *Capital calculations: Has the CCRO missed the point?*, Energy Risk, 1(3)

²⁴ Jakob Vestergaard and Martin Hojland, “The New Standard in Banking Regulation: From Basel II to Basel III”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.53

were expected to be achieved through the implementation of capital adequacy requirements, which were set at 8 percent.

Although capital adequacy requirements have arisen as the prevailing form of prudential regulation over the past 25 years, controversy still exists regarding the costs and benefits associated with them, both to private actors and society. Banks, for instance, perceive capital adequacy ratio as a type of 'regulatory taxation' when they are set higher than what they expected.²⁵ Thus, according to them, lower capital levels would lead to reduced funding costs, increased leverage and higher return on equity.

The Basel accords have strived to build a common international regime for the regulation of banks "by drawing up a series of minimum standards for the assessment of the amount of capital adequacy that banks should hold."²⁶ Capital requirements are part of a capital-based approach to banking supervision, which means the degree to which capital supports banks' activities. While capital adequacy ratio can be defined as "the proportion of a bank's total assets that is held in the form of shareholders' equity and certain other defined classes of capital, it is a measure of the bank's ability to meet the needs of its depositors and other creditors".²⁷ In other words, although it could be seen as a fairly crude measurement (capital to assets), it does help regulators to assess a bank's capacity to repay its depositors if they were to demand their money back. Two main shortcomings arise from this straightforward approach. First, it does not cover off-balance-sheet items, which are those that do not appear on the balance sheet of a company generally to avoid full disclosure of their assets and liabilities. With respect to the relationship

²⁵ Patricia Jackson et al, *Capital requirements and bank behaviour: the impact to the Basle Accord 1999*, BCBS Working Paper no.1

²⁶ Kevin Young, "The Basel Committee on Banking Supervision", in Thomas Hale and David Held, (eds), *Handbook of Transnational Governance*, Polity, 2011, p.40.

²⁷ "capital adequacy ratio" A Dictionary of Finance and Banking. Ed Jonathan Law and John Smullen. Oxford University Press, 2008. Oxford Reference Online. Oxford University Press. University of Ottawa. 13 December 2011

between off-balance-sheet instruments and capital requirements, “banks have used a variety of off-balance-sheet arrangements, typically involving securizations and special purpose vehicles, to avoid their obligations under the capital adequacy rules.”²⁸ Second, it does not take into account the different levels of risk associated with various portfolios of assets.

Minimizing the chances of banks’ failures is perhaps the most important purpose of capital regulation because such failures can cause substantial negative effects throughout the economy, as seen during the recent global financial crisis. When a bank fails, it has the potential to increase systemic risk, which is the widespread perception that the financial system as a whole could collapse. This in turn could be detrimental to the stability of the financial system. Thus, bank failures are deeply related to the social costs of financial instability. Some regulators, however, believe that capital requirements are not intended to prevent systemic risk, and therefore they should not be a concern of the Basel agreements. For instance, former Federal Reserve Chairman Alan Greenspan argued that “management of systemic risk is properly the job of the central banks” and “banks should not be required to hold capital against the possibility of overall financial breakdown”.²⁹

Albeit controversial, the understanding of this issue has been perceived as a matter of macro-prudential policy, thus part of the Basel agreement because, as witnessed in the recent crisis, financial markets’ instability led to a widespread systemic risk threat. As businesses lost confidence in the markets, investing and hiring slowed down. Thus, lack of growth and investment caused unemployment to rise. This vicious cycle can be avoided by decreasing the possibility of banks failures through capital requirements. Although in the majority of cases bank

²⁸ "off-balance-sheet" A Dictionary of Accounting. Ed Jonathan Law and Gary Owen. Oxford University Press, 2010. Oxford Reference Online. Oxford University Press. University of Ottawa. 20 July 2012

²⁹ Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation*, Peterson Institute for International Economics, 2008, p.22.

failures lead to acquisition by more solid institutions, only the threat of bank liquidation may trigger the scenario aforementioned. In sum, “a government’s decision on required capital levels necessarily involves a trade-off between the cost of capital to firms and individuals, on the one hand, and the possibility of disruptive bank failures, on the other.”³⁰

One of the worst consequences of the burst of the sub-prime ‘bubble’, which prompted the financial crisis, was the credit crunch that followed. Because complex, structured products had substantially lost their value, banks faced a huge decrease in liquidity in the market, and were unwilling to lend to customers and even to other banks as they were deeply concerned with others’ ability to repay loans. Thus, higher capital reserves tend to increase banks’ ability to tackle financial shocks. Nonetheless, from bankers’ perspective, perhaps the worst consequence of higher capital reserves is less profit and the need to change their business model as the banks will have to set aside a larger amount of money. In other words, in order to follow the regulations proposed by Basel III banks should proportionally increase the amount idly set aside. Having to set aside larger quantities of money, banks could reduce lending. As banks play a pivotal role in the world economy, less lending means more difficulties to, for instance, businesses to expand their factories and hire more workers. The prospect of less money available, therefore, harms the world economy’s recovery and poses an additional challenge to its full recover.

However, recent studies have shown that the costs associated with capital requirements are not as relevant as critics say. In fact, the understanding that ‘equity is expensive’ has been challenged as societal benefits outweigh any social costs. There are several factors that explain why. First, higher capital requirements do not mean that banks should ‘set aside’ funds otherwise meant for financing. Rather, these requirements “refer to how banks are funded and in particular

³⁰ Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation*, Peterson Institute for International Economics, 2008, p.26.

the mix between debt and equity on the balance sheet of the banks.”³¹ This is a misunderstanding between capital requirements and reserve or liquidity requirements, which “relate to the type of assets and asset mix banks must hold.”³² Thus, as these two requirements deal with different sides of the balance sheet, “there is no immediate relation between liquidity requirements and capital requirements.”³³ Second, the claim that higher capital requirements would lead banks to function at a suboptimal scale and to limit relevant social activities such as lending and deposit taking does not hold because, by changing their balance sheets, banks can conserve or extend lending activities. Finally, even though equity has a higher required return, this does not mean that the funding costs for banks will increase because the risk premium included in the required return on equity should decline due to higher equity used.

Later, on section 4, this paper will examine the claims by the financial sector regarding the negative consequences of higher capital requirements, particularly through the release of questionable studies, as part of a broader effort to water down the recent efforts to tighten capital adequacy ratio at the BCBS.

³¹ Admati, Anat R., Peter M. DeMarzo, Martin F.Hellwig and Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in Capital Regulation: Why Bank Equity is Not Expensive*, Stanford University Working Paper No. 86, 2010, p.2

³² Ibid, p.i

³³ Ibid

Section 3 – From Basel II to Basel III: a limited evolution

To have a good grasp of the current debate about Basel III, a brief overview of the framework advanced by Basel II is desirable. The second accord, whose first proposal was released in June 1999, was published on June 2004 after five years of negotiations. At the onset of the global financial crisis, the Basel II accord was in the process of being implemented. By 2007, the major European countries implemented Basel II as it had been incorporated into the European Union capital adequacy accord. Although Basel I and II had similar goals, they differed substantially in the way to achieve them.

Basel II was based on a three-pillar approach: (i) minimum capital requirements; (ii) guidelines on regulatory intervention by national supervisors; and (iii) guidelines on disclosure standards for banks.³⁴ Besides credit risk, Basel II integrated two other types of risks in its core provisions defined in Pillar 1: market risk, (i.e. the risk of losses in a portfolio due to movements in market prices), and operational risk (that is, the risk of losses resulting from inadequate or failed internal processes, people and systems, or from external events).³⁵

Despite the fact that Basel I and II had the same percentage of capital requirements (8 percent), the diverse methodologies meant significant differences among them with regards to capital requirements. Basel II was developed to promote a ‘risk-sensitive’ assessment when it comes to capital adequacy requirements. The rationale was that specific risk characteristics of each portfolio should determine the amount of capital put aside.³⁶ On the one hand, this individualized approach was designed to promote greater resource allocation efficiency and

³⁴ Jakob Vestergaard and Martin Hojland, “The New Standard in Banking Regulation: From Basel II to Basel III”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.55

³⁵ Ibid

³⁶ BCBS, *Basel II: International convergence of capital measurement and capital standards: A revised framework*, 2005

improved credit creation, which were highly desirable from politicians' perspective because it would lead to higher economic growth. On the other hand, banks would also welcome that approach as it enhanced their profitability because capital set aside would reflect the riskiness of a particular portfolio, not the entire range of portfolios.

The second pillar involved a supervisory review of the capital requirements mentioned earlier. Finally, the third pillar stated that banks should publicly disclose their financial positions and risk exposures. Overall, this approach was characterized as relying on “combined forces of bank owners and their risk managers, supervisor, and market forces”,³⁷ which substantially differed from the previous framework that solely relied on the supervisory process. Therefore, Basel II emphasized “the self-regulating ability of markets and the reputational credit of financial institutions as deterrents to excessively risky behaviour”.³⁸

In order to properly analyse the recommendations made by experts with respect to Basel III, it is essential to understand the main flaws within Basel II. The importance of these flaws is determined by how relevant they were to increase the severity of the global financial crisis. Despite being great on paper, the new methodologies did not achieve the desired outcomes. One of the main causes of this failure was the introduction of less capital requirements on trading books than on banking books, which had significant negative outcomes in international banking. Because banks had incentives to move assets from banking books to trading books in a process known as securitization, they transferred risks, both credit and market, from banks to capital markets. Thus, this practice was a dangerous dispersion of risks. Securitization meant greater profits for the actors involved due to a number of fees. Also, as non-tradable assets were transformed into liquid ones, it promoted higher liquidity in the market. More importantly for

³⁷ Elson, Anthony, *Governing Global Finance: The Evolution and Reform of the International Financial Architecture*, Palgrave Macmillan, 2011, p.162.

³⁸ Ibid

this paper, it decreased capital requirements for banks, which expanded credit in the market. The most recent financial crisis has shown that the combination of complex interconnected securitized products, higher liquidity in the market and low capital requirements can be extremely dangerous to the stability of the international financial system.

Moreover, Basel II introduced an internal ratings approach, known as an “advanced internal ratings-based (A-IRB)”, which essentially allowed banks to develop their own models to estimate several parts of credit risk. One major negative outcome derived from this approach was that “the use of internal ratings would result in large capital reductions relative to Basel I.”³⁹ In turn, capital levels in the banking system “would almost certainly decline”⁴⁰ because large banks have a relevant percentage of the market. According to U.S. regulatory agencies, based on their fourth Quantitative Impact Study (QIS) of 2006, a decrease in minimum capital requirements of approximately 15.5 percent would be a consequence of the A-IRB approach.⁴¹ Under Basel II, large banks, which have the capacity to build complex risk assessment models, would be able to determine their own internal risk models. If not, they would follow risk weights aligned with the ratings provided by credit rating agencies.

In essence, Basel II allowed lower minimum capital requirements if compared to Basel I, and promoted a competitive advantage in favor of large financial institutions as they were able to develop their own risk assessment. To sum up, the main criticisms regarding Basel II were: a) internal risk assessments severely underestimated capital requirements for large banks; b) credit rating agencies produced credit assessments of complex, structured products that seemed to

³⁹ Ranjit Lall, “Reforming Global Banking Standards”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.79

⁴⁰ Ibid

⁴¹ Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, 2006, Summary Findings of the Fourth Quantitative Impact Study <http://www.federalreserve.gov/newsevents/press/bcreg/20060224aa.htm> Accessed June 25, 2012

ignore the risks within them; they were, thus, unrealistic; c) banks did not report thoroughly their situation, particularly with respect to off-balance sheet transactions and extensive leveraged positions. Notice that these substantial criticisms highlight shortcomings in every pillar of the Basel II three-pillar approach.

Although Basel II was published on June 2004, by 2008 it was still in the process of implementation. As the crisis began on the summer of 2007, some experts argued that if such agreement were fully implemented before the crisis, the damage would have been less severe. However, in order to prevent similar crises from happening, or to minimize their harshness, analysts today agree that the second accord was insufficient even if fully implemented before the crisis because the flaws within its framework were significant – as highlighted in the previous paragraph. Financial regulation tends to adapt and evolve due to financial crises because the latter exposes flaws within the former. Hence, there needs to be another agreement with more stringent regulation to supplement Basel II. Basel III is the attempt to increase the resilience of the banking system, tackle the causes of the current financial crisis and thus prevent future crises from happening – at least in terms of their severity.

As early as September 2007, regulators, policymakers, and central bankers have discussed measures to tackle the global financial crisis in informal meetings. At that early stage, regulators debated the rules to force banks to reassess the way they handle liquidity in their operations, and eventually oblige them to hold more capital reserves if the instruments traded are seen as illiquid in a crisis. In addition, regulators considered imposing on banks the need to hold more reserves as a means to be prepared for contingent liquidity. However, the focus at that time was on improving some aspects of the Basel II agreement, particularly with regard to liquidity management and capital adequacy rules rather than aiming to develop a new accord. Therefore,

at the onset of the global financial crisis, reforming Basel II and improving its regulatory framework were still seen as adequate responses to the crisis.

Still at the onset of the global financial crisis, officials promised to make substantial reforms to the financial regulatory system. These early promises, however, have yet to be fulfilled.⁴² On October 2007, the G7 finance ministers stated their pledge to advance “fundamental reforms of the financial system”⁴³ in a package of changes to be delivered in their next meeting. Thus, policymakers were engaged in promoting significant reforms to the financial system. Despite this promise, their next meeting witnessed a substantial change in their attitude. Japanese officials, for instance, stated that if Basel II were fully implemented, the crisis might have been prevented. One official even argued that “the market was partially self-correcting and that huge losses would have a big chastening effect.”⁴⁴ This ‘step back’ was seen as an attempt to avoid overreaction to the crisis, and thus not promote measures that could lead to great difficulties in lending money – at that time, the crisis was spreading from the financial system to the ‘real’ economy, disseminating uncertainty in the markets and imposing a ‘credit crunch’ as the majority of the banks were unwilling to lend or unable to do so.

On October 2007, the BCBS issued a document called “Financial market development and the work of the Basel Committee” in which it strengthened the importance of full implementation of the Basel II framework, and that “the Committee also has been working to introduce new standards for banks to hold capital against the default risk associated with

⁴² Ranjit Lall, “Reforming Global Banking Standards”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.88-96

⁴³ Ranjit Lall, *Why Basel II failed and why any Basel III is doomed?*, Global Economic Governance Programme, October 2009, p.32

⁴⁴ David Pilling and Jonathan Soble, *G7 finance chiefs wary of overreaction*, Financial Times, February 9, 2008.

complex, less liquid credit products in the trading book.”⁴⁵ Nevertheless, there were neither specific measurements, nor deadlines to achieve these goals.

As the crisis strengthened, and due to “huge political pressure to be seen to do something”,⁴⁶ on April 16, 2008 the BCBS announced measures to increase the resilience of the banking industry, which focused on two important requirements, namely banks should keep higher capital reserve against complex structured products and off-balance sheet vehicles. These recommendations were designed to address capital requirement issues. Thus, the detailed new requirements regarding Pillar 1 were: a) “higher capital requirements for complex structured credit products”; b) “strengthened capital treatment of liquidity facilities extended in support of off-balance-sheet entities”; c) “strengthened capital requirements for assets held in the trading book”; d) “monitoring of Basel II minimum requirements and capital buffers over the credit cycle in order to determine if further measures were needed to help ensure a sound capital framework for addressing banks’ evolutions and complex risk profiles”.⁴⁷ Overall, these requirements would demand banks to increase their reserves as an attempt to decrease the industry’s risks because higher capital set aside would allow banks to deal more adequately with financial shocks. While the BCBS wanted to be perceived as an institution willing to take additional steps to improve its regulatory framework because of intense political pressure, it was clear that, at this point, it had recommended the minimum adjustments in order to be seen as responsive in the face of a global financial crisis. Moreover, even almost one year after the crisis began, the BCBS still promoted the implementation of the Basel II agreement as the best way to weather the crisis.

⁴⁵ BIS, *Financial market developments and the work of the Basel Committee*, 9 October 2007

<http://www.bis.org/press/p071009.htm>

⁴⁶ Peter Thal Larsen, Gillian Tett and Jennifer Hughes, *Banks face closer scrutiny*, Financial Times, April 17, 2008

⁴⁷ Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation*, Peterson Institute for International Economics, 2008, p.134

When the G20 finance ministers met again in London on April 2009, they decided, among other things, to keep the minimum level of capital unchanged until recovery is assured. This statement, almost two years after the initial signs of the financial crisis, substantially contradicts the previous declarations by the same authors, the G7 finance ministers. The astonishing difference on their perspective seems that the whole understanding of the causes of the financial crisis has suddenly changed – notice the title of this document “Declaration on strengthening the financial system”. In fact, it is plausible to argue that the previous statements reflected a partial commitment to achieve the earlier promises.

The BCBS released its new restrictions regarding capital, liquidity and leverage in December 2009, and it was criticized for proposing tougher than expected rules to address the financial crisis. However, by carefully reading the proposal, one identifies pronounced lack of crucial information regarding, for instance, timetable and exact requirements. Overall, the proposal consisted of rules that indeed intended to tackle the causes of the financial crisis. Yet it was unable to set pragmatic steps to implement them. According to the BCBS, in order to determine the actual numbers to apply, a process known as calibration, it needed to conduct several assessments. The disparity between rules and regulations, and concrete steps towards implementation prompted commentators to state that, although the rules are stringent, “the caveats on timetable and grandfathering mean that the final proposals are likely to be watered down”.⁴⁸ Even with these flaws, this package shook the financial industry and some claimed that this was a new era in banking regulation characterized by “more capital, more liquidity, and less risk”.⁴⁹

⁴⁸ Patrick Jenkins and Brooke Masters, *Tougher than expected framework leaves room for manoeuvre*, Financial Times, December 18, 2009.

⁴⁹ PricewaterhouseCoopers, *Capital management in banking: The way forward*, 2010, p.6

Nevertheless, a few months later, on July 2010, a compromise was reached between regulators and bankers based on rules less severe than first proposed. Later, on September 2010, when the BCBS released the new standards for banks, known as Basel III, critics pointed to serious flaws as well as relevant achievements. So far, the third Basel agreement has had eight consultative papers, five sets of principles, two impact studies and a number of guidance papers.⁵⁰ The crucial changes compared to Basel II are the implementation of higher levels of better quality capital, the creation of a leverage ratio, a liquidity ratio and a countercyclical buffer. These intend to promote greater banking stability and sustainable credit growth.

When comparing the capital requirements under Basel II and III, one might be led to believe that they have the same level of request as both determine that the minimum capital requirements remain at 8 percent of risk-weighted. However, this is not the case. Whereas Basel II imposed 4 percent of Tier 1 capital, Basel III requires 6 percent (75 percent of capital reserves have to be Tier 1). In addition, Basel III defines that 75 percent of this Tier 1 should be common equity, considered the highest quality form of loss-absorbing capital. Hence, common equity capital has become 4.5 percent of total assets. Moreover, a new capital requirement has been introduced, i.e. the capital conservation buffer, which determines a 2.5 percent of common equity capital as a means to tackle shocks. Altogether, the common equity requirements in Basel III are 7 percent as opposed to 2 percent under Basel II.

Although Basel III is praised as having increased capital requirements by three times (counting all measures, Basel III raises requirements to 8.5 percent), they are below the 10 percent U.S. capital requirements in recent decades.⁵¹ In addition, as Basel II's capital

⁵⁰ Jakob Vestergaard and Martin Hojland, "The New Standard in Banking Regulation: From Basel II to Basel III", in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.62

⁵¹ Simon Johnson, *Basel III: the fatal flaw*, The Baseline Scenario, 16 September 2010

requirements were very low compared to what experts had prescribed, three times “almost nothing”⁵² is indeed not a substantial increase. More importantly, financial economists have argued that capital requirements should be between 15 to 20 percent Tier 1.⁵³ According to Martin Wolf, Basel III requires a capital inadequacy ratio.⁵⁴ A recent study by the Bank of England recommends that “a far more ambitious reform would ultimately be desirable – a capital ratio which is at least twice as large as that agreed upon in Basel would take the banking sector much closer to an optimal position.”⁵⁵ It concludes by stating that “truly loss absorbing capital should be 16-20% of the best measure of risk weighted assets”⁵⁶, which further highlights the emerging consensus regarding optimal capital requirements to weather financial crises. Thus, focusing solely on capital requirements under Basel III, it is plausible to argue that, although it is a step in the right direction, there has only been a partial improvement if compared to Basel II.

In addition, Basel III still allows large banks to rely on their internal risk models to determine their capital requirements. As stated earlier, this characteristic of Basel II heavily influenced the boom and burst of the housing bubble as it reinforced “a combination of excessive reliance on a limited historical record and perverse compensation incentives”.⁵⁷ Nonetheless, some argue that banks are better equipped to develop these risk models as opposed to regulators, which have fewer resources. Furthermore, as Basel III grows in complexity in order to address the multitude of issues relating to banking regulation, it is plausible to argue that its complex

⁵² Martin Wolf, *Basel: the mouse that did not roar*, Financial Times, 14 September 2010

⁵³ Samuel G. Hanson, Anil K Kashyap, and Jeremy C. Stein, *A Macprudential Approach to Financial Regulation*, Initiative on Global Markets, Working Paper No. 58, 2010

⁵⁴ Martin Wolf, *Basel: the mouse that did not roar*, Financial Times, 14 September 2010

⁵⁵ David Miles, Jing Yang and Gilberto Marcheggiano, *Optimal bank capital*, Discussion Paper No. 31, Bank of England, April 2011, p.38

⁵⁶ *Ibid*, p.39

⁵⁷ Douglas J. Elliott, *Another Big Step Forward for the Basel III Bank Capital Proposals*, The Brookings Institution, September 13, 2010

arrangements and different requirements pose a further obstacle to implementation, and thus constrain the task of improving banks' soundness.

During the negotiation process, regulators had promised to include in the agreement an instrument called countercyclical buffer on top of the increased capital requirements (see details below). The purpose of such instrument, as the name shows, is to act as a countercyclical mechanism which would work both on economic booms and downturns. For instance, when an economy is facing an economic boom, the countercyclical buffer would be higher to decrease the likelihood of a bubble. During economic downturns, it would have the opposite effect, as it would allow banks to hold less capital. When Basel III was released, however, such capital buffer had not been included. In fact, it became optional and should be decided nationally.

The overextended transition period has also been heavily criticized as Basel III so far is expected to be fully applicable as late as 2019. Since the 1990s, severe financial crises have hit the global economy at least once a decade. Thus, it would be dangerous to allow the full implementation to take so long. Figure 1 shows the complete timetable to different ratios.

Basel III ratios and deadlines

Ratios	Basel II	Basel III	Deadline
Minimum Tier 1 leverage	n.a.	3%	2018
Risk-weighted ratios:			
1. Minimum Common Equity Capital	n.a.	4.5%	2015
2. Capital Conservation Buffer	n.a.	2.5%	2019
1+2=	n.a.	7%	2019
3. Minimum Tier 1	4%	6%	2015
4. Minimum Tier 1+2	8%	8%	2013
Countercyclical capital buffer	n.a.	0 - 2.5%	2019
Liquidity coverage	n.a.		2015
Net stable funding ratio	n.a.		2018
<i>Deductions from common equity</i>	n.a.		2018

Figure 1⁵⁸

⁵⁸ Karel Lannoo, *The forest of Basel III has too many tree*, Centre for European Policy Studies, February 2011.

Section 4 – Bank lobby and Basel III

As mentioned in the last section, on July 2010 a compromise was reached between regulators and bankers. Critics contend that the agreement represented a victory for bankers and “accuse regulators of caving in to industry lobbying”.⁵⁹ Evidence that bankers had the ‘upper-hand’ on that agreement is based on the following facts: “The net stable funding ratio was put off. The leverage ratio was eased and the effective dates for both were pushed away by nearly a decade”.⁶⁰ Hence, Basel III has yet to fulfill its early aims as the foremost international standard-setting body with respect to global banking regulation. Surprisingly, this has not been a unique case regarding the third accord. Basel II also had similar fate, and did not achieve its initial goals – see table below.

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

Figure 2 - Initial aims and regulatory outcomes in Basel II⁶¹

⁵⁹ Brooke Masters and Megan Murphy, *Suspense over*, Financial Times, August 19 2010

⁶⁰ Ibid

⁶¹ Ranjit Lall, “Reforming Global Banking Standards”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.86

The financial industry lobbying has played a significant role in shaping the Basel accords in order to ease their stringency and postpone their implementation. This has been a powerful argument especially after the Great Recession because the crisis has been blamed on two factors: “inadequate regulation that generated a mismatch between private reward and public risk; and failure of regulators to comply with their supervisory duties.”⁶²

In spite of considering different aspects when deciding the form of lobby to adopt, businesses tend to rely heavily on two of them: “The nature of the issue and the frequency with which similar issues occur”.⁶³ Regarding international banking regulation, particularly capital requirements policies, large banks are likely to be affected in the same way. In addition, regulation and supervision are recurrent issues concerning the financial industry. Thus, according to the framework proposed by Richard Lehne,⁶⁴ in which he identifies several patterns of business lobbying (four forms of lobbying based on the characteristics of one’s objectives), a business association is the best way for the financial industry to pursue its goals.

The business association in question is the IIF, which represents the financial industry globally, and lobbies regulators, policymakers and politicians. It self-proclaims to being the global association of financial institutions as it has more than 450 members headquartered in more than 70 countries. Its activities tend to be focused mainly at the international level. It is crucial to understand that although the IIF focuses its lobbying efforts at the international sphere, at the domestic level financial industry lobbying continues to advance its objectives through persuasion of national regulators and policymakers.

⁶² Walter Mattli and Ngaire Woods (eds), *The Politics of Global Regulation*, Princeton University Press, 2009, p.ix

⁶³ Lehne, Richard, *Government and Business: American Political Economy in Comparative Perspective*, 2nd Edition, CQ Press, 2006

⁶⁴ Ibid

Among IIF's main goals, two are particularly relevant to this paper: "systematically identify, analyze, and shape regulatory, financial, and economic policy issues of relevance to our members globally or regionally",⁶⁵ and "provide high-quality, timely, and impartial analysis and research to our members on emerging markets and other central issues in global finance."⁶⁶

Besides being an influential institution due to its powerful members, the technicalities associated with international banking regulation and the perception that international finance is crucial to a well-functioning world economy grant the IIF an expert authority that allows it to participate actively in the debates held in Basel and advance its opinions effectively. Therefore, although IIF's footprints are hard to identify as it is truly a secretive institution, these facts arguably allow the IIF to achieve its first goal.

The release of questionable studies by the financial industry is a powerful tactic used to disseminate misleading assumptions about regulatory efforts.⁶⁷ This tactic, which deeply relates to IIF's second goal previously mentioned, has been highly criticized by pundits as they see it as having extensive negative impact on regulators and policymakers.⁶⁸ The potential harmful outcomes of Basel III seem to be highly exaggerated. According to experts from different think tanks, the eventual negative effects are much lower than those argued by the banking industry.⁶⁹ For instance, the U.S. economy would "increase average loan pricing about 0.2 percentage points, with little effect on availability",⁷⁰ which means the impact on economic growth would be quite minimal, as opposed to the figures advanced by the financial industry, such as 3.2% of

⁶⁵ Institute of International Finance: www.iif.com Accessed February 20 2012

⁶⁶ Ibid

⁶⁷ Walter Mattli, *Banks are champions in watering down change*, Financial Times, August 20 2010, and Simon Johnson, *You Get What You Pay For*, New York Times, Economix, September 8, 2011

⁶⁸ Ibid

⁶⁹ Douglas J. Elliott, *Basel III, the Banks, and the Economy*, The Brookings Institution, July 26 2010 http://www.brookings.edu/papers/2010/0726_basel_elliott.aspx Accessed December 10, 2011.

⁷⁰ Ibid

global output down and 7.5m fewer jobs being created.⁷¹ The banking industry, other than the American one, has produced controversial predictions, such the 6% economic downturn of the French economy stated by its banking association.⁷² These scenarios are unrealistic as unbiased experts have shown: “my own analyses, and those of other disinterested parties, generally suggest a much smaller cost that would seem to be considerably outweighed by the safety benefits.”⁷³ In addition, the discrepancies between these figures are too high, and to some extent they seem to indicate a coordinated effort by the banking industry, especially the IIF: “The institute’s [IIF] report is nothing more than lobbying masquerading as economic analysis.”⁷⁴ According to Professor Walter Mattli, referring to the damage caused by misleading studies: “By the time this misinformation is corrected by serious impact studies, such as the analyses released this week by the Basel Committee on Banking Supervision and the Financial Stability Board, much damage has been done.”⁷⁵ Thus, “politicians’ fears about the impact of reform proposals are [not] disconnected from industry pressure.”⁷⁶ Furthermore, the IIF tends to frame regulations as generally intended to bind economic growth because they would reduce banks’ ability to lend, whereas in fact lack of effective regulation can be claimed to be one of the main reasons why the recent financial crisis was so severe as loose regulation allowed banks to hold insufficient capital to tackle potential crises.

In order to have a better grasp of the role played by the financial industry in shaping Basel III, it is necessary to return to the onset of the financial crisis. At that time, public perception regarding the financial sector was highly hostile and banking regulation had become a

⁷¹ Tom Braithwaite, *Bank capital rules ‘will cost 7.5m jobs’*, Financial Times, September 6, 2011

⁷² Douglas J. Elliott, *Basel III, the Banks, and the Economy*, The Brookings Institution July 26, 2010 http://www.brookings.edu/papers/2010/0726_basel_elliott.aspx Accessed December 10, 2011.

⁷³ Ibid

⁷⁴ Simon Johnson, *You Get What You Pay For*, New York Times, Economix, September 8, 2011

⁷⁵ Walter Mattli, *Banks are champions in watering down change*, Financial Times, August 20 2010

⁷⁶ Ibid

politicized topic. Thus, the G20, a prominent international group of political leaders, decided to weigh in on the issue of capital adequacy ratio. In fact, it backed capital requirements reform calling for international standard setters to “set out strengthened capital requirements for banks’ structured credit and securitization activities”.⁷⁷

Although when this statement was released the BCBS had not made any changes to Basel II yet, it managed to implement improvements to the Basel II trading book structure already in July 2009.⁷⁸ However, the G20 was not entirely satisfied with this slight enhancement, and asked the BCBS “to formulate a new set of capital rules that would form the centerpiece of an international framework for reform.”⁷⁹ This new package would consist of countercyclical capital buffers, international leverage ratio, more restrictive definitions of capital, and short- and long-term liquidity ratios. Ultimately, this was the December 2009 BCBS proposal which was seen by the financial industry as harsh and tough. Industry’s disappointment was evident as exemplified by IIF’s managing director stating that “political forces are driving the reform agenda, and central bankers have been marginalized in their role”.⁸⁰ After that proposal, as highlighted by the aforementioned compromise, Basel III has been highly criticized as weaker than expected to advance significant reforms to the global financial system.

The relationship between the BCBS and banking associations has also been condemned. Particularly since the 1990s, the BCBS has consulted with internationally organized groups even though these groups are perceived as representing the interest of large banks. The IIF has been cited as a business association that has met regularly with the BCBS. Because of the potential

⁷⁷ G20, Group of Twenty, *Declaration of the summit on Financial Markets and the World Economy*, Washington, DC, 2008, p.2

⁷⁸ BCBS, *Strengthening the resilience of the Banking Sector*, 2009

⁷⁹ Ranjit Lall, “Reforming Global Banking Standards”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.90,

⁸⁰ Florence Chong, *Bank fragmentation fears as politics overwhelms finance*, Asia Today Online, 5 November 2009

conflict of interests in this relationship, the literature has widely recognized the BCBS and its Basel agreements “as an example of ‘regulatory capture’ at the transnational level, whereby the content of the regulations has been systematically influenced by the very banks it seeks to regulate.”⁸¹ For a concrete example, please refer to Figure 2.

IIF’s aspiration to establish a privileged relationship with the BCBS has been evident for a long period. For instance, in December 1994, IIF’s managing director, Charles Dallara, wrote a letter to BCBS chairman, Tomaso Padoa-Schioppa, with two objectives in mind. Although the first is irrelevant to this paper, the second is telling: “[S]ince the IIF had a sizeable membership of the largest international banks and investment houses, it could be useful to organise a dialogue between them and key supervisory and regulatory officials.”⁸² BCBS chairman was at that time disinclined to allow any relationship between both organizations, even an informal and off-the-record one. However, Dallara insisted and in March 1995 he wrote another letter “to propose an informal discussion between senior representatives of prominent financial institutions and bank supervisors...to consider a wide-ranging agenda of regulatory issues, under the aegis of the IIF.”⁸³

Although Dallara again received a negative response, at the third time the situation had changed due to “the recognition that the models used by the leading international banks to measure market risk were actually much superior to the techniques proposed by the bank regulators and the BCBS itself...”⁸⁴ Thus, in 1996, “after careful consideration, the BCBS welcomed the IIF’s proposal to work with the regulators on the efficient implementation of the

⁸¹ Kevin Young, “The Basel Committee on Banking Supervision”, in Thomas Hale and David Held, eds, *Handbook of Transnational Governance*, Polity, 2011, p.42.

⁸² Charles Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years*, Cambridge University Press, 2011, p.415

⁸³ Ibid

⁸⁴ Ibid, p.415-6

models approach.”⁸⁵ In fact, this was a turning point in terms of the relationship between large international banks and regulators as previously (before the agreement) “almost all connection with individual commercial banks had been indirect and at arms’ length via the national bank supervisors.”⁸⁶

While technical cooperation is crucial to foster better banking regulation, the fact that banks had superior expertise than regulators and were now allowed a privileged position, through the IIF, should have raised concerns regarding the banking industry’s ability to steer the regulatory process to its benefit. Whereas Charles Goodhart contends that during the period analysed, from 1975-97, the BCBS had no evidence of ‘regulatory capture’ due to the fact that the “relative [banking] expertise only became recognised in the last year or so [1996-7]”,⁸⁷ this might have been the official establishment of a cozy relationship that turned out to be fruitful for the financial industry in the years to come as it formally allowed the IIF to have a privileged position at the BCBS both in terms of technical recommendation and its participation at the negotiation table.

The Basel accords have been created to address a global problem, which is the need to harmonize global banking practices as to improve the stability of the financial system and level the playing field. Critics, however, state that the Basel agreements are a clear example of regulatory capture,⁸⁸ which is defined as the “de facto control of the state and its regulatory agencies by the regulated interests, enabling these interests to transfer wealth to themselves at the

⁸⁵ Charles Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years*, Cambridge University Press, 2011, p.416

⁸⁶ Ibid

⁸⁷ Ibid, p.417

⁸⁸ Ranjit Lall, “Reforming Global Banking Standards”, in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.75.

expense of society.”⁸⁹ A more recent definition of regulatory capture states that “capture is the control of the regulatory process by those whom it is supposed to regulate or by a narrow subset of those affected by regulation, with the consequence that regulatory outcomes favor the narrow “few” at the expense of society as whole.”⁹⁰ In the case of the BCBS, therefore, regulatory capture means that the financial sector is able to dilute increased regulation to preserve its profits and business model at the expense of a poorly regulated global financial system, which is more prone to financial crises. In other words, private interests would capture the regulatory efforts and ultimately undermine social gains and maximize private profits. As a transgovernmental network, the BCBS has been characterized as an example of “transnational regulatory capture.”⁹¹

In order to identify the complexities associated with regulatory capture, several determinants of this phenomenon will be assessed firstly in terms of the broad financial policymaking process, and then particularly with respect to the Basel accords. The first component deals with “the asymmetric participation of different stakeholders in the financial regulatory process.”⁹² Although it is clear that the financial industry lobby has invested significantly in lobbying regulators and legislators, especially in the U.S. where US\$2.7 billion was spent in official federal lobbying from 1999 to 2008⁹³, financial resources are not the single cause of imbalance between stakeholders. In fact, some experts contend that the most important source of asymmetry comes from technical information.⁹⁴ When regulation focuses on a complex issue in which information asymmetries exist between regulators and regulated, capture is more

⁸⁹ George Stigler, *The Theory of Economic Regulation*, Bell Journal of Economics and Management Science (Spring 1971), 137-146

⁹⁰ Walter Mattli and Ngaire Woods (eds), *The Politics of Global Regulation*, Princeton University Press, 2009, p.12

⁹¹ Underhill and Zhang, *Setting the rules: private power, political underpinnings, and legitimacy in global monetary and financial governance*, International Affairs 84(3): 535-54

⁹² Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.8

⁹³ Americans for Financial Reform (2010). Wall Street Influence, By the Numbers.

⁹⁴ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.9

probable to occur. As financial industry regulation is highly complex, it highlights “the built-in advantage that the financial firms targeted by specific regulation have in terms of knowledge and information vis-à-vis other stakeholders”.⁹⁵ In turn, these aspects intensify the reliance on the regulated industry for technical expertise. Furthermore, other relevant stakeholders, namely investors, consumers and deposit holders, remain largely absent of regulatory debates due to disadvantages with respect to financial resources, technical expertise and “greater challenges in coordinating and in mobilizing the organizational and informational resources required to compete with the financial industry groups in the marketplace for influencing regulation.”⁹⁶ Since the recent financial crisis, however, greater engagement and participation have led to a more active role played by these actors.

Taking this broad debate about asymmetric participation in the financial regulatory process and applying it to the BCBS and its Basel accords, it is possible to identify several similarities. As there seems to be no requirement to public disclosure financial resources invested in lobbying at BCBS, one cannot gauge precisely the amount invested by the financial industry there. However, it is safe to say that the IIF and its members have lobbied heavily at the national level across different countries in order to influence regulators at the international level (BCBS) – see figures just mentioned on Wall Street’s banks lobbying U.S. authorities. Thus, financial resources available for the banking industry lobbying also play a role in influencing international regulators at Basel. Moreover, complexities that characterize financial regulation at the domestic level occur, and are even greater, at the international realm – for instance, the need to harmonize capital requirement policies across different jurisdictions can be daunting. Hence, financial firms’ technical expertise is also relevant in increasing the likelihood of regulatory capture at the

⁹⁵ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.9.

⁹⁶ Ibid

BCBS. Finally, public engagement, which has surged in many countries due to the financial crisis with important consequences at the national level, such as the Occupy Wall Street movement throughout the world, has reverberated at the BCBS. As stated earlier, political pressure from national governments at the G20 is just one example. Nonetheless, this increased political participation has yet to produce any concrete achievement with respect to the overall financial regulation.

‘Institutional context’ is the second determinant that can influence the outcomes of regulatory policies to be assessed, and it deals with the institutional framework. Generally, policies regulating financial issues are not designed by politicians themselves. Instead, independent regulatory agencies are implemented to achieve this goal. These agencies are formally independent and are usually created to mitigate “short-term pressures from politically influential stakeholders”.⁹⁷ Nevertheless, the institutional design of such agencies might support some stakeholders as financial sector groups have kept its favoured access to regulators and to engage with them “in an often opaque and discretionary environment, with many discussions occurring behind closed doors.”⁹⁸ The governance of regulatory agencies may also provide incentives that promote regulatory capture. For instance, some regulatory agencies depend on levies applied to financial sector firms as the chief source of funding.⁹⁹ Further, regulatory agencies’ boards sometimes have representatives of the financial industry, which implies possible influence on decisions and on the selection of executives.¹⁰⁰ The U.S. Federal Reserve system highlights this issue as regulated banks have their executives seating at the Fed board of directors when these banks received emergency funds from the U.S. central bank during the

⁹⁷ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.10

⁹⁸ Ibid

⁹⁹ Ibid

¹⁰⁰ Ibid

recent crisis.¹⁰¹ Finally, the extensive phenomenon known as ‘revolving doors’, which occurs between regulatory agencies and the financial industry, stresses the problematic hiring practices that end up incentivizing regulators to work in the financial industry, and vice versa (although to a less extent).¹⁰² Although this practice is widely known to happen in the U.S., a shift towards similar behaviour has been noticed in many jurisdictions, such as the UK. Nevertheless, some regulatory agencies, particularly in continental Europe, are recognized as institutions where bureaucrats spend most of their careers and perhaps most importantly where constraints discourage this transition.¹⁰³ According to theories of regulatory capture, the principle of ‘revolving doors’ have favoured the financial industry as former regulators are seen as having an unfair advantage over other professionals because they have inside know-how of agencies’ *modus operandi* and access to the regulatory agency.¹⁰⁴ Because regulators may end up working for the financial sector, this may incentivise regulators to become lenient towards potential future employers.¹⁰⁵ Despite the fact that the literature has not been able to present solid evidence, “some authors have argued that those regulators more likely to be hired by [the financial] industry are often those that are tougher in their supervisory activity.”¹⁰⁶

With respect to BCBS’ ‘institutional context’, it is certainly a regulatory agency established at the international level in an effort to define and reach agreements regarding banking regulation globally. Thus, it is designed to mitigate the shortcomings associated with short-term pressure from politically persuasive participants. However, the lack of transparency with respect to BCBS’s meetings and decisions has had a negative impact on its ability to

¹⁰¹ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.11

¹⁰² Ibid

¹⁰³ Ibid

¹⁰⁴ Ibid

¹⁰⁵ Ibid

¹⁰⁶ Ibid

promote adequate policies across the board. The phenomenon of ‘revolving doors’ can be seen as detrimental at the international level as well because BCBS’s regulators might also perceive internationally active banks as potential employers, which in turn would lead to a less stringent regulatory role played by international regulators – as tougher regulators have a higher chance of moving to work with the financial sector. As aforementioned, the implications of the problems associated with the institutional context are yet to be fully determined. Nonetheless, if these issues are truly present at the BCBS, they are significant enough to encourage a behaviour that contributes to ‘regulatory capture’.

The third element is known as ‘intellectual capture’ and it differs from previous determinants as it does not deal with material incentives. Rather, it touches on issues related to “regulators’ ideas, beliefs, and mind-sets” as factors that can influence policy outcomes. This recent element has begun to be analyzed mainly due to the recent financial crisis. By analyzing the pre-crisis state, this behaviour is highlighted, such as Fed’s perceived excessive concerns with both asset prices and fears of Wall Street.¹⁰⁷ Further, prior to the crisis regulators regarded as “natural” the use of models and datasets created by private actors without considering issues of public interest and systemic risk.¹⁰⁸ Even prominent regulators, such as Lord Adair Turner, chairman of the Financial Services Authority (FSA), have argued that the intellectual *zeitgeist* empowered the banking lobbying to persuade regulators, which in turn promoted regulatory capture.

Although there seems to be a general agreement with respect to the concept of ‘intellectual capture’, the causes related to this kind of capture are still contentious. On one hand, some say that it reflects the dominant economic paradigm that was in place by and large

¹⁰⁷ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.11-12

¹⁰⁸ *Ibid*, p.12

unchallenged prior to the global financial crisis. Financial markets' efficiency in allocating risks, their self-stabilizing aspect, and the advantages of financial innovations for the real economy were some of the concepts that shaped "the broader intellectual climate of the period".¹⁰⁹ As a result, relevant legislation advanced during that period reflected the same understanding mentioned above. This included Basel II and others that relied heavily on market discipline.¹¹⁰ On the other hand, the roots of 'intellectual capture' have been found within the regulatory process itself. As regulators and the financial industry interact constantly, this could contribute to regulators adopting similar assessments related to regulatory issues as the financial industry they regulate. Moreover, this interaction ends up promoting more social networks between regulators and financial firms than between the former and consumer groups or other stakeholders.¹¹¹ Thus, this sort of close affinity between these two sets of players may encourage a process of convergence of ideas that could lead to 'intellectual capture'.¹¹²

Whether one can clearly observe this determinant of regulatory capture at the international level or not, it is plausible to argue that the process aforementioned that occurs at the national level may be replicated at the global level. This is due to the fact that, for instance, the same interaction between regulatory agents and the financial industry that exists at the domestic arena may also happen internationally. In addition, the same economic dominant paradigm that influences regulators at the national level is also present at the global realm even though there might be more diverse views at the negotiation table in a global scale, if compared to negotiations in one jurisdiction. Nevertheless, as decisions at Basel are reached mainly on a

¹⁰⁹ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.12

¹¹⁰ Ibid

¹¹¹ Ibid

¹¹² Ibid

consensus base, those international regulators that have different perspectives than the prevailing mind-set may be persuaded to follow the majority.

The final determinant deals with how politicians may influence the work of regulatory agencies, which is known as ‘capture through the political process.’¹¹³ There are at least two potential ways in which politicians may interfere in the regulatory process. First, they are the ones who define the responsibilities of regulatory agencies. Second, the ability of such agencies to achieve their goals highly depends on their capacity to work towards them. Hence, agencies’ funding, which is determined by politicians, is crucial to allow them to work properly. Overall, politicians may have a decisive role in shaping the performance of financial regulatory agencies.

Politicians’ actions, however, may be driven by different factors. The financial industry is known as being one of the major financial contributors to politicians during electoral campaigns. Ultimately, this could influence the voting behaviour of politicians based on the interests of those who fund their campaigns. Further, politically speaking, politicians’ survival deeply relies on short-term goals. Yet regulatory agencies policies, mainly focused on long-term goals, may lead to relevant externalities throughout the economy. This, in turn, may encourage politicians to interfere in such agencies policies in an attempt “to achieve short-term political objectives by pleasing powerful electoral constituencies or special interest groups, regardless of changes in the legislation.”¹¹⁴ Politicians’ interference in regulatory agencies may be explained by the occasionally conflicting relationship between electoral cycles and business (economic) cycles. For instance, when an economy is booming, politicians may pressure regulatory agencies to either postpone policies designed to prevent ‘bubbles’ or to adopt less stringent rules as a means to allow the economy to keep growing, and help their re-election plans. On the opposite

¹¹³ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.13

¹¹⁴ Ibid

side, when an economy faces a downturn, politicians may want harsher than necessary rules to be seen as tough on the financial industry – if they are perceived as the main source of the downturn –, and thus extract electoral rewards. On neither circumstance, the appropriate level of regulation is attained. Rather, lenient or punitive regulation may worsen the problem at hand. Hence, due to the inherent characteristic of both electoral and economic cycles, the likelihood of financial regulation being capture through the political process is “cyclical rather than static phenomenon, alternating between periods of crisis and boom.”¹¹⁵

Politicians’ interference on regulatory agencies’ can also happen at the international level. BCBS has been the target of several demands from the G20 leaders in part due to the global financial crisis. This has produced undesirable outcomes such as the aforementioned episode when regulators were under immense pressure to produce a set of regulations, the harshest possible, to respond to the global financial crisis. It was clear that politicians were more concerned with public opinion and the need to be seen as doing something to punish the financial industry instead of focusing on the best rules to tackle the crisis at hand, as well as to prevent similar crisis from happening. Hence, although international regulators are less prone to political pressure if compared to domestic regulators as international agreements of this sort need to be ratified domestically prior to being enforced nationally, they are still susceptible to capture through the political process.

Throughout the discussion concerning the determinants of regulatory capture in financial regulation, it is clear that this is a complex phenomenon that has multifaceted aspects and causes. Factors ranging from the ability to mobilize diverse stakeholders, the prevailing economic ideas in place, the institutional context and the larger economic and political context

¹¹⁵ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.14

are all influencing, even if not simultaneously, the outcomes of most financial regulation. There are two causes that highlight why financial regulation is so prone to regulatory capture: “The information-intensive nature of financial regulatory policies and the proximity with market participants which is required for regulators to stay abreast of market developments.”¹¹⁶ However, although it is unlikely that such risks can be abolished, there are mechanisms designed to alleviate their effect. This paper, therefore, now turns to the analysis of policies that can contribute to mitigate regulatory capture in financial regulation at the international level.

4.1 – Policy agenda to mitigate regulatory capture at the international level

4.1.1 – Participation of stakeholders in the regulatory process

As aforementioned, the active role played by the financial industry in being a very vigorous voice in the regulatory process can be detrimental because they may expose regulators to only one side of the evidence available.¹¹⁷ In that sense, it is desirable to increase the participation of different stakeholders in this process. Strengthening the plurality of voices would also promote a debate between diverse participants who tend not to share the same ideas. By concentrating their efforts against each other, “they are less likely to be able to support narrow special interest regulation.”¹¹⁸ Finally, greater participation of different stakeholders in the regulatory process would decrease the likelihood of ‘intellectual capture’ as this would bring varied ideas and viewpoints into the regulatory process. There are three ways to achieve this goal. Creating participatory mechanisms such as public consultations are policies that intend to ensure the active involvement of a variety of stakeholders in the regulatory process. Nevertheless, due to the

¹¹⁶ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.14

¹¹⁷ Ibid, p.15

¹¹⁸ Ibid

intricate nature of financial regulation and financial industry's informational advantage in these consultations, particularly at the international level, such mechanisms are unlikely to be meaningful in avoiding capture.¹¹⁹

Tripartism and proxy advocates are also policies meant to level the playing field in a more decisive manner. The former is designed to allow groups with a diffuse membership, mainly consumers and investors, to secure an advantaged place within the regulatory process. This mechanism entails the engagement of regulators in strengthening “the voice of those real economy interests whose representative is more fragmented.”¹²⁰ The participation of regulators with consumers, for instance, would promote better use of consumer agents' restricted resource through better consultations, and would present more effective ways for consumers “to present complaints to which regulators need to respond within a defined timeframe”.¹²¹ Despite having the potential to work as a “form of affirmative action”¹²² in the financial regulatory process, these policies are severely constrained due to consumers' agencies being often “small, disperse and underfunded.”¹²³ Moreover, greater participation by different stakeholders in the policymaking process would only be possible with the support of policymakers. Funding of consumers' groups through subsidies is just one example. Proxy advocates is a policy designed to create internal agencies as a means to guarantee that a consumer standpoint is provided to regulators. These agencies would embody the public interest in the decision making process and could eventually challenge regulatory policies.¹²⁴ Obstacles to achieve proxy advocates' goals exist in the form of these bodies location within the organization, along with their restricted

¹¹⁹ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.15-16

¹²⁰ Ibid, p.16

¹²¹ Ibid

¹²² Ibid

¹²³ Ibid

¹²⁴ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.17

financial resources.¹²⁵ As a result of these impediments, external bodies, fully independents, with the capacity to set their own agenda and able to publicly express their opinions have been perceived as a desirable solution.¹²⁶

Another possibility to increase the participation of different stakeholders is through enhancing the competition within the financial industry. Diverse forces from the financial industry would work to minimize the risk of capture. The rationale to this policy is that there are players within the financial industry that perceive banking regulation as a desirable mechanism to promote long-term stability and thus restore confidence in the financial system.¹²⁷ Although it is plausible to portray the situation as aforementioned, the reality is that short-term concerns have come to dominate the efforts by financial groups in the policy area.¹²⁸

4.1.2 Reforming the institutional context

While increasing the engagement of diverse stakeholders is desirable to avoid capture, mitigating institutional biases, which is the main goal of reforming the institutional framework, is perhaps even more important because if the institutional design is seen as unduly favouring specific interests, different stakeholders' participation will do little to mitigate this problem. Although statutory independence of regulatory agencies is a prerequisite safeguard, particularly to tackle short-term pressures from politicians, it is not enough. Several additional design features must be in place so an agency is able "to achieve its long-term mission relatively free from capture."¹²⁹

¹²⁵ Ibid

¹²⁶ Ibid

¹²⁷ Ibid

¹²⁸ Ibid

¹²⁹ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.18

The internal decision-making process of regulatory agencies is a crucial element that needs to be taken into account. The periodic rotation of agencies' staff is needed to circumvent excessive like-mindedness with market players. Also, an internal mechanism of peer review would grant greater scrutiny to the regulatory process, along with guaranteeing "that the most important decisions, such as those around capital, liquidity, the overall supervisory evaluation and enforcement action are taken by a committee rather than by individual supervisors."¹³⁰ In addition, as a means to avert intellectual capture, the implementation of new decision-making processes, such as to allow decisions to be assessed by different stakeholders with diverse mind-sets and backgrounds, would promote the participation of alternative and dissenting views. A step further with regard to improving the institutional design, as recommended by IMF's Independent Evaluation Office (IEO),¹³¹ would be to engage regularly with prominent external specialists particularly in areas of relevant divergence. IEO also prescribes that staff are encouraged to "speak truth to the power" regardless of the official understanding of a regulatory agency on the topic at hand, along with allowing staff to advance reports without an official endorsement.¹³² The institutionalization of such practices would increase the exchange of different viewpoints and create a healthy debate within regulatory agencies.

4.1.3 – Staffing and Recruitment

The focus here is to minimize the existence of 'revolving doors', as explained earlier. Two broad views have been developed. One that states that regulators should not be allowed to find jobs at

¹³⁰ Ibid, p.19

¹³¹ IEO, *IMF Performance in the run-up to the financial and economic crisis: IMF Surveillance in 2004-07*, Independent Evaluation Office of the International Monetary Fund, 2011

¹³² Ibid

the financial industry, and prospective regulators should preferably have no background in the financial industry.¹³³ The second view argues that, due to the nature of financial regulation, one that requires technical expertise, potential candidates could only be found among those who have “a direct experience working with the financial services industry.”¹³⁴ According to this view, the outcome would be detrimental to regulatory agencies, which would not be able to recruit candidates with significant experience. In fact, the best solution would be to have regulators with great market experience while striving to avert potential conflict of interests.¹³⁵ If the second view is to be adopted, several policies are required in order to minimize capture. First, full transparency on regulatory agency’s and financial industry’s hiring processes. Public disclosure of regulators’ ties to the private sector, as well as a minimum period of years among regulators being able to work within the financial sector – the reverse should also be true: regulators should not work in matters related to their former private-sector employer.¹³⁶ These employment restrictions would ultimately fix the atypical occurrence of regulators with connection to the banking industry that exemplifies the majority of senior positions and the board of diverse financial regulatory bodies, as well as still letting these bodies hire the necessary expertise in the market.¹³⁷

4.1.4 – Regulatory agencies’ funding

The final set of institutional modifications deals with the nature of funding of regulatory agencies. One of the primary contributors to the phenomenon of ‘revolving doors’ is the

¹³³ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.20

¹³⁴ Ibid

¹³⁵ Ibid

¹³⁶ Ibid, p.21

¹³⁷ Ibid

compensations offered by public and private sectors. Underfunding restricts the capacity of regulatory agencies to compete with financial industry to retain experienced staff. Further, fewer resources limit the ability of public sector to do research and generate knowledge.¹³⁸ Paradoxically, as a response to the global financial crisis, regulatory agencies have witnessed an increase in their duties that have not been met with greater funding to perform these extra obligations. This, in turn, maximizes the issue of lack of appropriate funding of regulatory agencies. Hence, adequate funding is crucial to ease the risk of capture as greater resources would increase their capacity to hire and retain experienced regulators, along with better chance to foster researches.

The source of funding has also been a matter of debate. Although alternative forms of funding based on a levy upon specific financial institutions have been advanced, these would only increase the likelihood of capture as regulators would perceive a greater sense of obligation towards firms that fund their activities.¹³⁹ A mixed model characterized by a differentiation between funding and control – the former coming from the private sector, and the latter would be overseen by the government – seems highly unfeasible.¹⁴⁰

¹³⁸ Stefano Pagliari (eds), *Mitigating Capture in Financial Regulation*, International Centre for Financial Regulation, 2012, p.22

¹³⁹ *Ibid*, p.23

¹⁴⁰ *Ibid*

Conclusion

As witnessed in the recent crisis, large financial shocks have ramifications throughout the real economy. For instance, millions of jobs worldwide were lost due to the Great Recession. This is just to highlight BCBS' social purpose, which is to minimize the chances of banks' failure. It has also an extremely important role to play when it comes to financial regulation globally. Nevertheless, just to mention one relevant limitation, most of its staff is on temporary secondment from other regulatory agencies. Being the most influential regulatory agency and facing inadequate funding is inexcusable, particularly because BCBS is maintained by the group of the twenty wealthiest countries in the world. This raises questions such as BCBS' ability to hire and retain talented professionals with adequate expertise – regulators that earn competitive compensations are less prone to leave regulatory agencies and join the financial sector.

Moreover, Basel III is designed to harmonize banking practices, especially related to capital requirements due to the global financial crisis. In essence, Basel regulation seeks to impose higher capital requirements to riskier activities. In addition, international financial regulation is also important to internationally active banks as they perceive it as a better choice if compared to different regulations at the national level. This unified global approach thus is seen as an important element in order to level the playing field, which would increase the likelihood of similar rules across the globe to international banks.

Although the exchange of ideas and the participation of diverse stakeholders is very healthy to the decision-making process at the BCBS, the undue influence exercised by the financial sector has jeopardized this process. Technical information, financial resources, and adequate mobilization have worked well for the financial sector throughout the second Basel

agreement, and so far during Basel III. The following figure illustrates the likely regulatory outcomes in the last Basel accord.

Initial Proposal	Industry Recommendation	Likely outcome (Basel III)
Introduce international leverage ratio in Pillar 1 (i.e. binding)	Move to Pillar 2 (i.e. non-binding)	Ratio made non-binding until at least 2018; set at only 3%
Create capital surcharge for 'systemically important' institutions in Pillar 1	Drop surcharge	Removal or adoption in Pillar 2
Introduce countercyclical capital buffers in Pillar 1	Move buffers to Pillar 2	Adoption in Pillar 2
Exclude minority interests and tax deferred assets from common equity base	Drop proposal	Proposal abolished in July 2010
Introduce short-term liquidity coverage ratio (LCR) and longer-term net stable funding ratio (NSFR)	Use less demanding stress scenarios for both ratios; widen definition of liquid assets under LCR; shift NSFR to Pillar 2	Relaxed stress scenarios for both ratios; wider definition of liquid assets under LCR; NSFR moved to Pillar 2 until at least 2018

Figure 3 - Initial proposals and likely regulatory outcomes in Basel III¹⁴¹

When massive crises hit the world economy, there is always a chance of significant improvements being made as a means to avoid the same mistakes from happening again, such as after the Great Depression. In perspective, the current Basel III framework is greatly a missed opportunity even though it is clearly an improvement if compared to Basel II. However, due to the magnitude of the recent crisis, the inability of regulators and policymakers to push for a more robust agreement is telling. Once approved, a new Basel framework would have a great chance of being implemented thoroughly as states have strong incentives to adopt it.

With respect to the policy agenda examined earlier, it is crucial that other stakeholders also have a chance to participate systematically in the decision-making process at the BCBS. A

¹⁴¹ Ranjit Lall, "Reforming Global Banking Standards", in Stefano Ponte, Peter Gibbon and Jakob Vestergaard, (eds), *Governing Through Standards*, Palgrave Macmillan, 2011, p.95

greater exchange of ideas would unequivocally decrease the likelihood of intellectual capture. The cozy relationship between regulators and the financial industry has occurred nationally and internationally, which is an additional obstacle in order to implement the policies suggested in the last section. Even though the mechanisms of tripartism and proxy advocates are better suited to the challenge, they still face significant obstacles. Further, the ability to create a clash of ideas between financial players does not seem feasible as the largest financial firms are those who tend to control the efforts by the financial industry at the BCBS. Hence, diverse voices within the financial sector would mostly be silenced by larger players.

An improved institutional design is perhaps the most promising policy alternative. A periodic rotation of agencies' staff, an internal mechanism of peer review, and an overall supervisory evaluation and enforcement actions taken by a committee rather than by individual supervisors are highly desirable. In addition, constant exchange of ideas with prominent external specialists, particularly in areas of relevant divergence, may avert regulatory capture. Actions deliberately designed to regulate as much as possible the mechanism of 'revolving doors' would safeguard regulatory agencies from the constant flight of regulators, and allow these agencies to retain experienced professionals. Further, a comprehensive review of regulatory agencies' funding would be extremely desirable for many reasons, as aforementioned. One of the most important is the fact that with appropriate funding regulatory agencies would also be able to generate knowledge through research, initiate dialogues with similar institutions, and engage with financial firms on equal terms – as opposed to what happens today.

Finally, Basel III's requirements are part of the international macro-prudential regulatory framework that strives to enhance the soundness and safety of the banks, thus protect the entire global finance system. Although in theory progress has been made through Basel III's approval

by the major global economies, in practical terms it remains to be seen whether or not all the measures approved will be fully implemented, which is expected by 2019. In turn, this long implementation process could allow the banking industry to pursue less stringent regulation. Simultaneously, Basel III has been characterized as a missed opportunity to increase the soundness of the financial system – which, as previously shown, has also occurred to Basel II. In order to abolish this trend, several policies advanced by this paper have the potential to decrease the likelihood of regulatory capture.

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