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ABSTRACT

Financial safety nets are incomplete social contracts that assign responsibility to various economic sectors for preventing, detecting, and paying for potentially crippling losses at financial institutions. This paper uses the theories of incomplete contracts and sequential bargaining to interpret the Basel Accords as a framework for endlessly renegotiating minimal duties and standards of safety-net management across the community of nations. Modelling the stakes and stakeholders represented by different regulators helps us to understand that inconsistencies exist in prior understandings about the range of sectoral effects that the 2004 Basel II agreement might produce. The analysis seeks to explain why, in the U.S., attempting to resolve these inconsistencies has spawned an embarrassingly fractious debate and repeatedly pushed back Basel II's scheduled implementation.

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BASEL II: A CONTRACTING PERSPECTIVE*

This paper uses the concepts of regulatory arbitrage, sequential decision-making, and incomplete contracting to explain why Basel II has so many loose ends and why U.S. efforts to implement Basel II have been roiled by controversy and delays. Perceived as a forum for reregulation, the Basel Committee on Banking Supervision (BCBS) enlists supervisory authorities (“regulators”) from financial-center countries to work together to control regulatory arbitrage and to promote financial integration and better risk management (Barr and Miller, 2006; Pattison, 2006). But the success of BCBS negotiations is limited by the largely nonbinding nature of the agreements its members ratify and by divergences in the interests and political clout of the economic sectors BCBS conferees represent.

For this reason, the original 1988 BCBS Accord (Basel I) and its successor Accord (Basel II) are better viewed as a collection of strategic guidelines than as systems of rules. The agreements neither spell out explicitly the quasi-fiduciary duties that banking regulators owe to their counterparts in other countries nor explain how such duties are to be enforced when they conflict with the interests of stakeholders to whom they are politically accountable.

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BCBS negotiations are founded on the premise that group expressions of regulatory intentions are something more than cheap talk. How much more is unclear. The Accord fails to include clauses that could make regulators in individual countries directly accountable to one another for enforcing the standards the BCBS promulgates. Additional weaknesses exist both in the methods used to test Basel II arrangements for their effects on the cross-country and within-country distributions of financial-institution risk and regulatory capital and in the methods that were originally used to set the 4-percent and 8-percent capital standards.

Section I underscores the nontransparency of pre-Basel and post-Basel dealmaking between governmental and industry stakeholders in individual countries (on the one hand) and the negotiating teams that participated directly in the Basel contracting process (on the other). The analysis demonstrates how a contracting perspective can help us to understand the protracted, sequential, and sometimes waspish nature of Basel-related negotiations and the gaps in regulatory accountability the Accord deliberately embraces.

Prior to letting agents undertake cross-country negotiations, it is optimal for interested economic sectors in each country --as principals-- to exchange understandings with their particular negotiating team. Each understanding is meant to constrain the concessions that the particular sector may be asked to absorb. Because inconsistencies in sectoral understandings are unavoidable, individual-country negotiators must insist that cross-country agreements incorporate design options (called “national adaptations and concretions” by Kette, 2006) that leave contract terms incomplete. National regulators need these options to placate principals that might feel short-changed (or even betrayed) by the international agreement. The hope is that these options can be employed to craft subdeals that are mutually acceptable to competing interests in their home countries.

Section II describes the major options conveyed to banks and regulators by the Basel II agreement. Although negotiators prefer not to acknowledge this, adherence to cross-country guidelines will be tempered by the force of contrary domestic pressures and by the severity of financial troubles that different economies experience. Government responses to political and crisis pressures in the past indicate that clientele, career, and bureaucratic interests tend to outweigh international considerations. In tough times, whatever concern individual regulators might have for preserving or enhancing their standing within the international regulatory community (emphasized, e.g., in Whitehead, 2006) will not matter very much.

Section III proposes a simplified nonmathematical model that can explain how inconsistencies in the predeal understandings and goals of interested domestic parties poisoned post-Basel bargaining in the United States. Section IV identifies some possible paths for resolving contradictory concerns. The path of least resistance may be for regulators to abandon the link between reductions in regulatory capital and the extent to which an institution actually improves its risk management.

I. Viewing the Basel Accord as an Incomplete Multilevel Contract

The fairness and efficiency of the explicit terms of the contract (or “deal”) constructed in Basel fall short of the Basel Committee’s stated goals of promoting comprehensive risk management and consistency in international regulatory standards. However, just as our view of a forest might be blocked by its trees, the redeeming social value of Basel negotiations as a multilevel and intertemporal strategy-making process can be obscured by focusing only on difficulties observed in particular outcomes.

Marking off particular sequences of negotiations and assigning them a discrete numeral misses the essential continuity and inconclusiveness of the patch-by-patch contracting process. This paper conceives of negotiation outcomes at any date T as “Basel (T)”: the value of an integral equation whose kernel “ $B(t)dt$ ” is driven by the goals that stakeholders (S_{ik}) in each of m different countries ($k = 1, \dots, m$) hope to achieve and the resources (R_{ik}) they plan to invest in lobbying for these goals.

Figure 1 identifies the so-called “pillars” of the Basel II Accord. Although the diagram depicts the pillars to be of equal height and thickness, especially with respect to risks (such as interest-rate risk in the banking book) that are not part of Pillar 1, the second and third pillars have been hollowed out by lobbying efforts and may not support much weight. Until and unless the incentives of banks and regulators are better aligned with those of ordinary citizens, Pillar 2 options may be too feeble, too opaque, and too riddled with conflict from regulatory competition to provide reliable reinforcement for the other pillars.

It is important to recognize that Basel II asks rather than forces national regulators to behave in globally appropriate ways. Realistically, it frames a renegotiation game that binds officials only to monitor and to think about the global consequences of actions taken by the institutions they regulate. The outcome of this game is apt to prove more favorable for some countries than for others.

As mutable multinational agreements, the contracts the BCBS writes establish an intertemporal structure within which to renegotiate complicated multiparty relationships. They are not treaties because signatories represent regulatory agencies rather than sovereign governments. Individual negotiators and the people they report to are short-lived agents for numerous long-lived principals. The principals are constituencies that are modelled here as

concerned sectors of each agent's home economy. Each tentative contract that agents consider in Basel promises to pass a series of rights and obligations through to the negotiators' home constituencies.

Within a country's government, financial regulators are expected simultaneously to supervise and to represent conflicting constituencies. Contracting theory presupposes that costs of reading and writing contracts are minimized. To minimize the total costs of negotiating with foreign and domestic constituencies, Basel II negotiations proceed in three phases. Prior to conducting dealmaking sessions in Basel, each negotiator must prenegotiate hard and soft constraints on its ability to accept deals that might disadvantage its politically powerful domestic principals. It is useful to think of these restrictions as *predeal understandings*. An understanding is neither as sharply worded nor as enforceable as a formal contract. To the extent that understandings are not made public, particular constituencies can interpret their understandings in ways that might well be inconsistent with understandings furnished to one or more other sectors. Moreover, as parties with a personal and organizational interest in the game, negotiators may find it advantageous on key issues to accept soft constraints that they subsequently plan to violate.

Each time cross-country negotiators adjust the system's strategic guidelines to meet objections raised by agents for particular constituencies, negotiators returning from Basel have to describe changes in the cross-country deal and reconcile them with prior understandings. Third-phase recontracting occurs separately with other concerned officials within a given government and with interested sectoral constituencies. In this phase, negotiators are apt to paint their need to renege on predeal agreements as if they were

necessitated by what they learned in Basel about the constraints faced or imposed by foreign negotiators.

Tables 1 and 2 model the Accord's main stakeholders in the U.S. and Europe, respectively. Table 3 models the stakes.

Within countries, financial institutions hoped that Basel II would redistribute safety-net costs and benefits among competing governmental and sectoral interests in advantageous ways. For U.S. regulators, the stated purpose of the negotiations was to enhance financial stability. As the negotiations wore on, negotiators from the European Union seemed more interested in using Basel II to promote regulatory integration. The European Parliament apparently wanted to establish a uniform framework for internationally active European banking groups without burdening regional banks operating mainly in national markets.

Like bodily health, stability cannot be traded from one party to another. It is what Maskin and Tirole (1999) and Hart and Moore (1999) characterize as an "undescribable" variable. Negotiators assume stability can be proxied and that the proxy can be defined as the absence of worrisome forms of financial disorder. More concretely, Basel II presupposes that changes in stability can be represented by obverse movements in the probability and loss severity of the particular disorders (such as economic insolvencies and operational breakdowns) that adjustments in the Accord seek to hold at bay. Implicitly, every draft of the Basel Accord embodies a projection of how selected control variables (especially variously defined capital ratios) affect the components of a larger-dimensional space of global welfare. The implicit projection that Basel II will reduce individual-bank or systemic risks is largely hypothetical. Empirical support consists mainly of qualitative inferences about how widely recognized forms of risk-taking, risk transfer, and risk support undertaken by individual

financial institutions or their regulators ought in theory to affect a subset of default probabilities and loss severities in question.

Incompleteness

In a world of changing governments, it is impossible for one generation of regulators to craft a contract that can firmly precommit their successors. In a world of changing financial technology, the list of contractable triggers of instability can never be completely described. For both reasons, explicit contractual rights and duties must have slack built into them. In principle, the loose ends are intended to allow individual-country regulators enough flexibility to expand their catalogue of approved and disapproved behaviors over time as unforeseeable circumstances dictate. In practice, loose ends are reciprocal options that allow safety-net subsidies to be distributed nontransparently to private financial interests.

From this practical point of view, the most disturbing loose ends concern Basel II's treatment of large and complex banking organizations. Regulators need the vision to see through the accounting numbers to the true condition of the institutions they supervise and the incentives to respond appropriately to what they see. A bank's opacity, political clout, and organizational ability to arbitrage regulatory systems increase both with its size and with its complexity. Even within countries, clever rogues or desperate managers can book particular loss exposures in ways that are too opaque for regulators to monitor and discipline them effectively. It is possible that data-collection and risk-measurement standards under Basel II are so loosely specified that close adherence to them in making business decisions can support an increase rather than a decrease in insolvency risk at many banks. To lessen this danger, capital requirements under Basel II ought to incorporate a measure of opacity and impose an

additional opacity-related capital requirement to account for the opportunities that large and complex banks have to relocate exposures across instruments and borders to avoid detection and/or to lessen their exposure to Pillar 2 discipline.

A good contract is easy to understand and creates incentives for its fulfillment. From the perspective of the individual constituencies, hard-to-decode loose ends are options that can be characterized as opportunities for regulators to renegotiate or reinterpret the agreement when unforeseen or unspecified contingencies arise (Ben-Shahar, 2004; Foss, 1996).

Retaining flexibility is a good thing, but granting flexibility to a contractual counterparty authorizes it to act adversely to one's interests. No matter how well-intentioned, any contract as complex as Basel II must be feared (Rasmussen, 1996). The remedies for this fear are trust and independent analytic ability, but neither of these remedies is costless for an individual agent or stakeholder to establish.

An agent builds trust by making itself accountable for results. An agent builds accountability (A) in three ways: by making its actions and motives transparent, by bonding its commitment to the principal's interests, and by giving the principal the power to deter opportunistic behavior. Bonus clauses and reputational costs are forms of bonding. An opportunistic agent's exposure to retribution from the principal has a deterrent effect.

For every stakeholder ($S_j, j = 1, \dots, n$), the value of each imbedded option k ($O_{jk}, k = 1, \dots, m_j$) depends on the degree to which stakeholder j can reasonably trust the option's counterparties to behave competently and nonopportunistically. At Basel, agents failed to bond the Pillar II activities of foreign regulators to the goal of financial stability or to negotiate the kinds of inter-regulator and public disclosures that would reliably buttress market discipline by allowing independent experts to assess the quality of Pillar II activity.

U.S. negotiating teams are not personally accountable to voter-taxpayers for these omissions. Members were allowed to renegotiate Basel I without direct Congressional involvement or approval. What accountability exists comes nontransparently from post-Basel negotiations with other U.S. regulators and industry groups. Ironically, these groups' ability to win new concessions traces to their option to lobby Congressional committees to weigh in on their side.

As post-Basel dealmaking evolves, the net value of an *uninvolved* sector j 's collection of implicit options $\left(O_j = \sum_{k=1}^{m_j} O_{jk} \right)$ are unlikely to be fully counterbalanced by the value of the net benefits or burdens conveyed by the explicit and enforceable terms of the contract (B_j). This is because involved sectors that see the deal as exposing them to harm have a strong incentive to hold up --or even to blow up-- the deal.

II. Options Conveyed to Banks and Regulators by Basel II

Prudential regulation of financial institutions seeks to balance the social costs and benefits of individual-country safety nets. Both Basel Accords recognize the possibility that the cross-country operations of aggressive multinational banks or opportunistic interventions by their regulators can upset this balance.

Government intervention in finance leads to a protracted series of collisions between political and economic forces (Kane, 1981 and 1984). Basel II represents the third stage in a dialectical sequence of regulation, burden avoidance, and eventual re-regulation. The patterns of the regulatory arbitrage and response that Basel I induced are unusual in three ways. First, almost all banks have chosen to hold capital positions that are greatly in excess of minimum

standards and want to continue to advertise themselves that way. Second, any bank that found the minimum standards burdensome could almost costlessly close the gap by securitizing low-risk loans and thereby increase its portfolio risk to raise its desired level of capital to the regulatory minimum. Third, around the world, banks and regulators support the effort to narrow this loophole by increasing the granularity of the risk categories used in setting capital standards.

Besides increasing the number of risk categories, Basel II proposes to use a mix of statistical methods and expert opinion to track a bank's changing exposure to insolvency risk over time. It also envisions improved disclosure as a way to generate complementary market discipline on bank capital positions. However, Basel II does not improve on Basel I either in how it measures capital or in the arbitrary target ratios it sets.

Although influenced by prior consultation with other stakeholders, the June 2004 agreement known as Basel II reflects direct bargaining only among members of the Basel Committee on Banking Supervision (BCBS). Basel II leaves a number of options open for regulators in individual countries to use in renegotiating prior understandings among themselves and with various client institutions.

Basel II is not easy to understand and promises to generate options that have undesirable incentive effects. It grants national regulators an option to use any (or all) of three different schemes to determine the regulatory capital of client banks [see Kupiec (2005 and 2006), Pennachi (2005), U.S. Comptroller of the Currency *et al.* (2006), and Viets (2006) for details]. In turn, where a country authorizes more than one scheme, some or all banks receive the option to adopt whatever scheme they find most beneficial (or least burdensome) and to implement the scheme they choose in the most advantageous way. By exercising their options

optimally, similarly situated banks in the same country or in different countries could end up with widely divergent levels of required capital. Indeed, this is what the five Quantitative Impact Studies (QIS1 to QIS5) conducted under the aegis of the BCBS have shown (Kupiec, 2006).

The most important option concerns whether or not to use an Internal-Ratings-Based (IRB) Approach or the Standardized Approach to determine an individual bank's capital requirement. The simpler Standardized Approach resembles Basel I, except that it incorporates a wider range of weights and asks countries to choose a set of external rating agencies and use these agencies' assessments of risk to determine country-level capital requirements. IRB Approaches allow banks to specify and submit for validation their own "internal" models to calibrate their exposure to insolvency risk. Basel II distinguishes the so-called Foundation IRB (FIRB) model from the Advanced IRB (AIRB) model for constructing these estimates and calculating minimum capital requirements. For each individual credit, both models require banks to specify a probability of default (PD), a "loss given default" (LGD), and an expected exposure at default (EAD). The FIRB approach differs from the AIRB in specifying rules for calculating EAD and in using a single LGD for all of a bank's credits. In calculating EAD, FIRB ignores the possibility that the rate of credit-line drawdown and borrower PD are likely to be driven by common factors (Kupiec, 2007).

The internally generated data are plugged into a correlation function based on characteristics of each credit and then passed through a model that ultimately produces a probability distribution of potential losses over the next year. Minimum regulatory capital is determined by the requirement that the bank must be able to absorb all but the last 0.1 percent tail of losses displayed by this *synthetic distribution*. How artfully a bank parametrizes this

distribution is difficult to constrain. Because capital is costly, savvy regulators expect that most banks will use legitimate reporting options to understate their true loss exposure to some degree. Ideally, regulatory protocols for validating models under the AIRB ought to focus on estimating how fast the uncovered tail of the *true* loss distribution might grow when and as various circumstances cause a bank's economic capital to decline (Kane, 2006).

III. A Non-Mathematical Model of Post-Basel Contracting in the United States

It is convenient to define \bar{I}_j as the information and expertise needed to evaluate accurately the option values O_j and net contractual benefit or burden B_j stakeholder j faces from a proposed deal. Gaps can exist between \bar{I}_j and the information and expertise I_j that constituency j or its agent a_j actually possesses. When these gaps are not fully appreciated by a constituency or its agent(s), it is unlikely that its interests will be adequately safeguarded. Rationally, constituencies that simultaneously do not trust their agents to represent their interests energetically and have enough information to perceive adverse movements in their stake in the Accord should exert pressure to prolong the deal-making until one or the other condition can be repaired.

To understand post-Basel developments in the U.S., it is helpful to construct a model. My model supposes that in each participating country ($q = 1, \dots, Q$), national regulators are agents whose respective objective functions W_q combines welfare from four sources:

1. *Personal* rewards to leaders (p_q);
2. *Bureaucratic* benefits obtained for their particular organization through regulatory competition (b_q);
3. Benefits generated for *client financial institutions* (f_q);

4. Mission-driven safety-net benefits that flow through to the representative *voter-taxpayer* v_q).

Post-Basel bargaining occurs both between U.S. agents and between every agent and its principals. Although all four federal deposit-institution regulators participated in Basel II discussions, the New York Fed and the Board of Governors exercised a commanding leadership role. The Fed's leadership role among central banks was inherited from Basel I and adversely affects its ability in the post-Basel process to treat other U.S. regulators as equal participants. In Basel, the Board and New York have always had separate votes in the negotiations. Moreover, when Basel II discussions began, sister central banks occupied most of the seats at the BCBS table. As supervisory functions began to be split off from European central banks, the new supervisory agencies were incorporated into the negotiation process, but no central bank surrendered its place in the process.

For modeling purposes, it is convenient to assume that Fed employees negotiated the U.S. position in Basel, but now must negotiate implementation issues with other U.S. financial regulators taken as a group. I call the collective group the Federal Deposit Insurance Corporation Plus (FDIC+) because I assume that these regulators' twofold concern in post-Basel negotiations is to defend the interests of their particular regulatory clienteles and to protect the deposit-insurance fund against the possibility that large banks might be able to operate in a low capital position.

For simplicity, I assume that Fed personnel focus on maintaining their employer's position of global leadership with foreign regulators and its reputation for supporting financial innovation with large financial holding companies. Table 1 lays out how the FDIC+ members channel the interests of other depository institutions.

I also assume that Congress and the Administration project that, over their expected terms in office, voter-taxpayers are prepared to trust financial-institution regulators until and unless either they create a public controversy or systemic financial problems emerge. If either event occurs, elected politicians plan to jump in and mete out blame.

To maintain their capacity for shifting blame, politicians will accept any system on which the Fed and the FDIC+ can agree, but any regulator or any industry segment can persuade politicians and voters to examine and defend their stakes in the outcome if negotiations proceed badly enough for their side.¹ Finally, I assume that, because of its less-elitist clientele and minimal contact with foreign regulators, the bureaucratic costs of exercising this or other hold-up threats is much less for members of the FDIC+ than for the Fed.

Incentive Conflicts in Post-Basel Negotiations

Conflicts between the social missions of regulators and the interests of the sectors they regulate cannot be avoided. Post-Basel negotiations must resolve not only these conflicts, but also conflicts among the missions and clienteles assigned to different regulators.

The interests of the nation's largest institutions in inter-regulator negotiations are also conflicted. On the one hand, standards that would be tough enough to assure financial stability would help large banks by lessening the expected value of the FDIC's right to levy ex post assessments to finance losses that exceed the value of the FDIC's insurance fund. On the other hand, they want to compete as strongly as possible with foreign institutions. Figure 3 illustrates that the very largest institutions may reasonably think of themselves as too big to

¹ House Financial Services Committee Chairman Barney Frank was quoted in a February 20, 2007 American Banker column on "Washington People" as saying: "My basic concern [about the Basel process] is that I have to pay attention to it and it gives me a headache. It's Rubik's cube – every time you do one thing, six other people get upset."

fail and unwind. In this case, they should resist standards tough enough to preclude them from pursuing heavy tail risks that extract government-contributed capital from the safety net.

Neither Basel II nor U.S. regulatory protocols include specific plans for resolving large multinational financial organizations. The obvious opportunities for risk-shifting that this gap in planning poses leads me to infer that the nation's largest banks do not want a benchmark resolution protocol to be designed and tested. As a group, they may believe that an unstructured environment would enhance their ability to lobby for forbearances and/or to negotiate away their assessment exposure if a large bank were actually to become insolvent. This hypothesis can explain why large U.S. institutions continue to lobby uniformly for further capital relief.

At each agency, the vast majority of employees are involved in supervising and servicing their clienteles. This creates a bureaucratic interest in preserving the size and competitive positions of their clientele. At the same time, no member of the FDIC+ community would like to test the system's ability to resolve the insolvency of a giant firm. For both reasons, these agencies are bound to oppose adjustments that promise to increase the probability that a large institution might become economically insolvent.

Policymakers agreed at the outset that their goal was to improve risk management at large banks, not to help banks to operate with markedly lower levels of capital. In the predeal phase, U.S. regulators agreed publicly that very large U.S. banks² would be required to use whatever version of the Advanced IRB approach (AIRB_{us}) regulators finally authorize. Other U.S. institutions could choose, but only between the AIRB_{us} and a Standardized approach.

² The mandate applies to banks or thrifts that have either \$250 billion in total assets or \$10 billion in assets held abroad.

The second part of the understanding among regulators was that the overall level of U.S. bank capital would not be allowed to decrease much under Basel II. “Much” is of course a word that could be interpreted differently by different constituencies. Behind this understanding lay regulators’ statutory duty under the FDIC Improvement Act of 1991 to define a series of leverage-ratio triggers for Prompt Corrective action (PCA) intervention that are tough enough and transparent enough to make authorities accountable ex post for losses suffered by the federal insurance fund. FDICIA designates an unweighted leverage ratio of two percent as the threshold at which an undercapitalized bank that does not promptly recapitalize itself must surrender its charter. However, the numerical value or accounting tripwires that require lesser interventions are set by interagency agreement.

Perhaps because they fear that PCA requirements impinge on Fed independence, Federal Reserve personnel often mischaracterize regulatory concern for the leverage ratio as a transitional safeguard meant to “backstop” Basel protocols for banks whose information or control systems might initially mishandle the complicated AIRB capital calibration. However, Congress and the FDIC+ recognize that simplicity and transparency of the leverage ratio creates the personal and bureaucratic accountability that ultimately enables PCA requirements to restrain capital forbearance.

PCA obligations and the second understanding undermined predeal assurances afforded the banking industry that individual banks that designed and operated state-of-the-art risk-management systems would be rewarded with reduced levels of regulatory capital. In an offhand effort to sort out the conflict in understandings, one Fed Governor – Governor Susan Schmidt Bies – was quoted as saying, “The leverage ratio down the road has got to

disappear.” This was good news for large institutions, because the disappearance of leverage-ratio triggers is a development they favor.

However, the length of this road was noticeably extended by the outcome of the fourth Quantitative Impact Study (QIS4). As Figure 2 shows, QIS4 indicated that if the 26 bank holding companies surveyed met only AIRB-generated requirements, 17 of them would show a leverage ratio that PCA standards would classify as undercapitalized.

This result was both surprising and disturbing. It was surprising in that it seems as if the quantitative staffs at these 17 giant holding companies used QIS4 survey instruments to demonstrate to their superiors how effectively Basel II would let them arbitrage restrictions on leverage without stopping to appreciate the parallel danger of demonstrating this same capacity to regulators in other industry segments. The outcome was disturbing in two ways. First, it supports the hypothesis that quantitative personnel at large banks and the Fed have been the engine driving the Basel II train in the U.S. and that disconnects exist in the way members of this staff interface with the rest of their organization. Second, neither the competitive upheaval nor the threat to the deposit-insurance fund that these results implied was sustainable politically. Smaller members of the FDIC+ clientele demanded that the formulas embodied in the Standardized Approach be recalibrated to afford them equal capital relief, whether or not they did anything to improve their risk management. This scaled-down capital standard has come to be known as “Basel IA.”

IV. Where Can Regulators Go From Here?

In September 2005, the Fed and the FDIC+ took the first step in the post-Basel process of formally reconciling inconsistent understandings about bank prospects for capital

reduction. Regulators agreed that, during the first three years of implementation, no individual bank's Basel II capital would be allowed to drop more than 5 percent a year, relative to pre-Basel II standards. In March 2006, U.S. regulators indicated [and in September 2006 stated in a massive notice of proposed rulemaking (NPR)] that if aggregate capital held by AIRB banks fell by 10 percent, they reserved the right to redesign the AIRB system. Because QIS4 tells us that this so-called "transition floor" might be hit in the second year, a 10-percent reduction is likely to be the recalibration target for which large banks and FDIC+ clienteles will lobby.

This rewriting of predeal understandings not only reduces projected returns at large banks and thrifts, it leaves the entire industry less trustful of the options they are likely to enjoy under the still-evolving regulatory system. All parties are annoyed that the time and resources invested in supervisory negotiations and bank measurement systems have not yet produced a workable arrangement. Undoubtedly, large-bank investments in risk-management systems promise a mix of regulatory and nonregulatory benefits -- not just regulatory ones. However, divergences between the AIRB model and a large bank's own risk-measurement protocols create deadweight costs. Compliance costs could be greatly reduced by monitoring and frequently revalidating the internal models each large bank uses, while allowing large banks' formal capital requirements to be set by the standardized approach.

In July 2006, four giant institutions -- Citigroup, JPMorgan Chase, Wachovia, and Washington Mutual -- openly asked to renegotiate their stake by requesting that large U.S. banks be granted the option either to help design improved AIRB formulas or to use something like the Standardized approach that competing European banks enjoy. On August 3, the American Bankers Association sent a letter to Dr. Bernanke and leaders of the FDIC+

asking “the agencies to permit U.S. banking organizations of all sizes the option of adopting alternative methodologies.”

While Federal Reserve Chairman Bernanke previously dismissed this option, large banks and FDIC Chairman Bair are challenging his answer. To get large banks back on the train, the Fed may have to postpone the AIRB mandate and can justify this as buying time to incorporate and test “promising” new advances in risk modeling. In a February 2007 comment on the 2006 NPR, the four banks attacked the transition floors and the relevance and validity of the QIS4 data that spawned them. The banks also reasserted their claim that the provisions officials agreed to add to Basel II convey unfair competitive advantages to foreign banks.³ Since other U.S. regulators are in no hurry to adopt Basel II in any case, the main costs of temporarily making AIRB optional would be a slight loss of face in the international regulatory community for the Fed and for individual personnel most closely identified with implementing the 2004 agreement. Finally, the four banks’ February 2007 comment asks that level and composition of the leverage ratio be reviewed.

To maintain financial stability, the choice of PCA triggers must feature the idea that a sustained decline in the accounting value of capital is a lagging indicator of bank weakness. Other nonnegotiable points should be to continue to make tough and transparent leverage-ratio thresholds the key to identifying failing and zombie firms and to continue to give these thresholds incentive force by mandating that every agency’s Inspector General conduct a thorough “material loss review” whenever an institution it supervises imposes a substantial loss on the insurance fund. A conscientious material loss review publicly unveils a failed institution’s supervisory history in excruciating detail. The credible threat of ex post

³ If true, the fault lies either in the procedures used to validate IRB models in particular countries or in the absence of PCA requirements from Basel II (Nieto and Wall, 2006). It is instructive to note that European banks routinely express the opposite fear.

accountability for imprudent forbearances fuels the incentive force that supervisors feel from PCA standards.

A dangerous path on which regulators might embark would be to surrender control of the inevitably politicized capital-assessment process in the hope that, in the not-too-distant future, transparent and reliable statistical methods for objectively measuring risk exposure will emerge. It might seem defensible to measure risk exclusively by IRB procedures at strongly capitalized banks if the Basel approach to risk-weighting were made truly comprehensive, but measuring bank risk is not the role that the leverage ratio plays in PCA. However, Basel protocols will always contain loopholes. It is no accident that regulatory forbearance can gain cover from Pillar I's neglect of the concealment options created by the complexity of a bank's balance sheet and of exposures to interest-rate risk in its banking book. Hence, even if regulators could take account of all of a bank's loss exposures, it would still be necessary to counter nontransparencies in the forbearance pressures that agencies might experience. For this reason, taxpayers need the simpler tests embodied in PCA thresholds to trigger reliable end-game regulatory discipline.

Whatever regulators decide about risk weighting, to strengthen leverage-ratio triggers for troubled banks, they ought also to tighten their definition of capital to incorporate market-value losses. Consistent with evidence presented by Berger, Davies, and Flannery (2000), leverage-ratio supervisory triggers would be improved if accountants were required to define contra-asset loan-loss reserves as the higher of either: (1) incentive-conflicted estimates now routinely prepared by bank personnel or (2) estimates generated by a rolling-regression model that agency researchers would update and apply each quarter.

Politically, the path of least resistance appears to be a different one: to focus post-Basel negotiations on lowering minimum regulatory capital in a way that equalizes the competitive effects of capital-requirement reductions across regulatory clienteles. In this case, rather than being designed to provide a better measure of risk sensitivity and to reward improvements in risk management made by individual institutions, I would bet that capital requirements finally specified in Basel IA for community banks and in options that might be opened for large banks would each be calibrated to reduce regulatory capital to a level approaching the U.S. regulators' previously specified 10 percent transition floor. If political pressures force the FDIC to accept this outcome for minimum capital, I would urge the FDIC to use its authority to raise explicit deposit insurance premiums as a bargaining chip with which to persuade the other agencies to toughen the definitions and levels of capital that trigger prompt corrective action obligations.

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Appendix

Fact sheet - Basel Committee on Banking Supervision

Functions

The Committee provides a forum for regular cooperation on banking supervisory matters. Over recent years, it has developed increasingly into a standard-setting body on all aspects of banking supervision.

Membership

Senior officials responsible for banking supervision or financial stability issues in central banks and authorities with formal responsibility for the prudential supervision of banking business where this is not the central bank.

Institutions

National Bank of Belgium	Banking and Finance and Insurance Commission
Bank of Canada	Office of the Superintendent of Financial Institutions
Bank of France	General Secretariat of the Banking Commission
Deutsche Bundesbank	Federal Financial Services Agency
Bank of Italy	
Bank of Japan	Financial Services Agency
Surveillance Commission for the Financial Sector (Luxembourg)	
Netherlands Bank	
Bank of Spain	
Sveriges Riksbank	Swedish Financial Supervisory Authority
Swiss National Bank	Swiss Federal Banking Commission
Bank of England	Financial Services Authority
Board of Governors of the Federal Reserve System	Office of the Comptroller of the Currency
Federal Reserve Bank of New York	Federal Deposit Insurance Corporation

Chairman

Nout Wellink, President of the Netherlands Bank.

Vice Chairman: Nicholas LePan, Superintendent of Financial Institutions, Canada.

Secretariat

Secretary General (as from 4 September 2006: Stefan Walter), supported by a staff of 14.

Frequency of meetings

The Basel Committee usually meets four times per year.

Reporting arrangements

The Basel Committee on Banking Supervision reports to a joint committee of central bank Governors and (non-central bank) heads of supervision from the G10 countries.

Outreach

The Committee maintains links with supervisors not directly participating in the committee with a view to strengthening prudential supervisory standards in all the major markets. These efforts take a number of different forms, including:

- the development and dissemination throughout the world of policy papers on a wide range of supervisory matters;
- the pursuit of supervisory cooperation through support for regional supervisory committees and sponsorship of an international conference every two years;
- cooperation with the FSI in providing supervisory training both in Basel and at regional or local level.

Main subgroups

- Accord Implementation Group
- Capital Task Force
- Accounting Task Force
- Core Principle Liaison Group
- Cross Border Banking Group
- Research Task Force

Figure 1

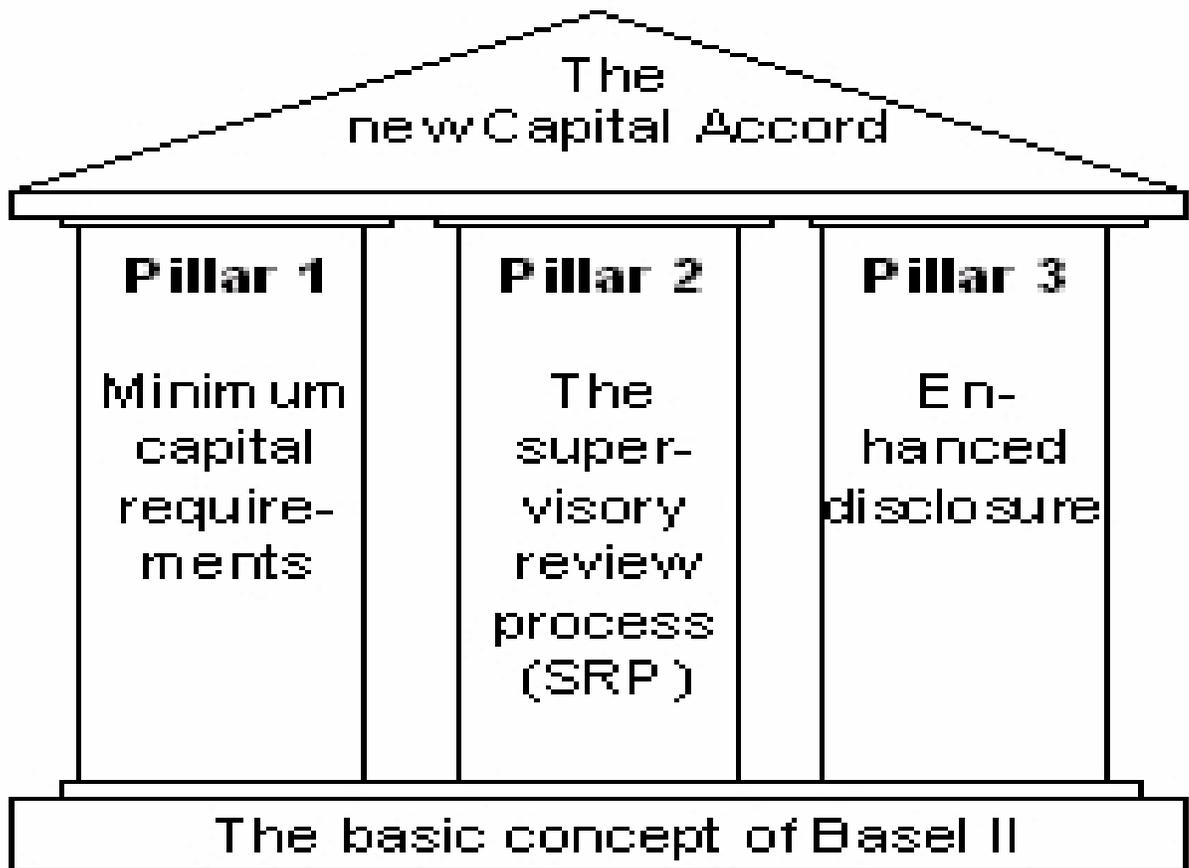
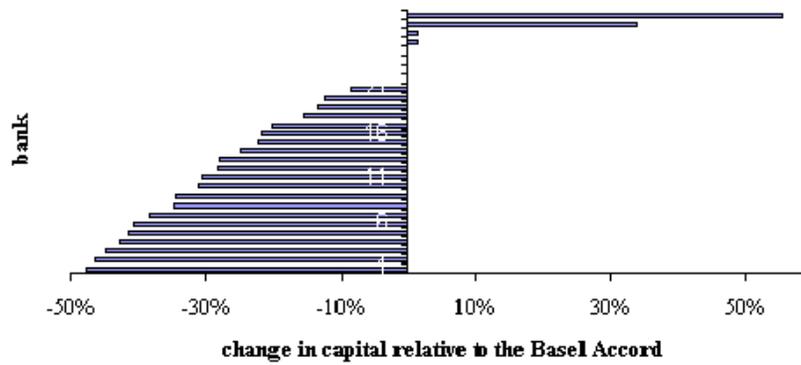


Figure 2: Estimates of Effective AIRB Changes in Minimum Required Capital of QIS4 Banks

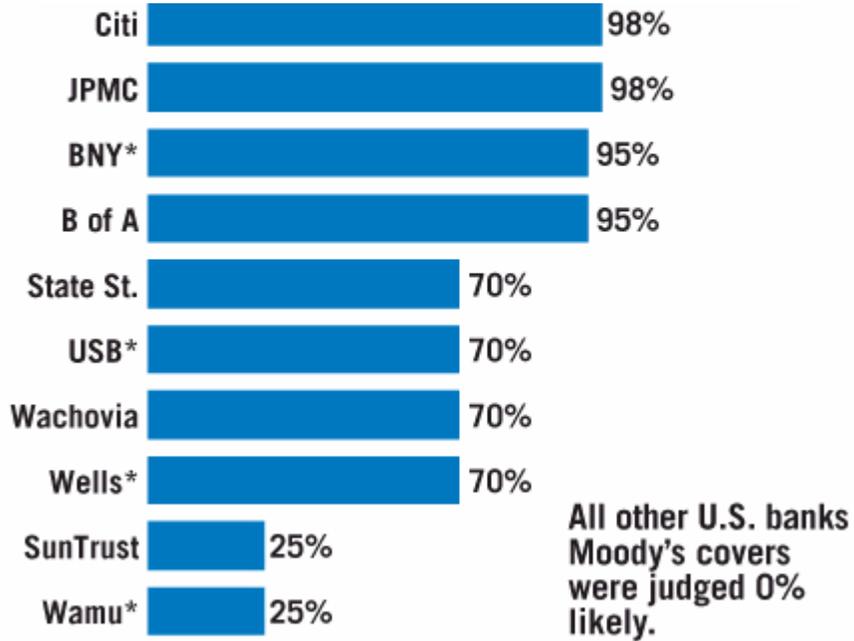


Source: FDIC

Figure 3

**GIANT BANKS NEED LESS
ENTERPRISE-CONTRIBUTED CAPITAL**

Moody's now assesses U.S. banks' likelihood of getting "systemic support" when needed.



*Multiple bank affiliates received score

Source: American Banker, March 7, 2007.

Table 1

Model of U.S. Stakeholders and Clienteles

- I. Federal Reserve Board and NY Fed (lead negotiators for the U.S.)
 - a. Quantitative Staff at Fed (stake = advancement & “street creds”: e.g., John Mingo)
 - b. Successive Leaders of Basel II push
 - Early leaders: William McDonough and Larry Meyer
 - Successors: Roger Ferguson, Susan Bies, and Randy Kroszner
 - c. Broad Stability Mission: Stabilize Liquidity; Oversee Domestic and International Value of the Dollar; Promote Systemic Stability
 - d. Special Clientele: Larger Financial Holding Cos. and Their Quant. Staffs
- II. Other Federal Regulators: The FDIC+
 - a. FDIC
 - Mission: Resolve Insolvencies and Protect the Integrity of the DI fund.
 - Special Clientele: Community Banks; Conference of State Bank Supervisors
 - b. OCC
 - Mission: Supervise National Banks and Strengthen their Charter
 - Special Clientele: Money-Center and Regional Banks
 - c. OTS
 - Mission: Support mortgage market (i.e., keep Basel risk weight for mortgages low), Strengthen S&L charter, and supervise S&Ls
 - Special Clientele: S&Ls & Building Industry
- III. Congress & Administration
- IV. Voter-Taxpayers

Table 2

Main Stakeholders in Europe

- I. CHANGING MIX OF CENTRAL BANKS AND FINANCIAL SUPERVISORY AUTHORITIES
 - a. Mission of Central Banks: Stability of Every Kind
 - b. Mission of FSAs: Application of Basel Across Countries and Institution Types (Increased Supervisory Authority and Uniformity as well as Financial-Institution Stability)
 - c. IOSCO et al.
 - d. Clienteles: Systemically Important Institutions
(Trend is for European central banks to transfer responsibility for fin. stability to FSAs and to apply the Basel approach to every kind of financial institution.)
- II. ECB and Other Authorities in European Union
 - a. Mission: To promote political and economic integration (uniform rules)
 - b. Clientele: Sponsors of political and economic integration in Brussels and elsewhere.
- III. Elected Officials in National Governments
- IV. Voter-Taxpayers

Table 3

STAKES	
First-Order Stake of U.S. Negotiators Is Enhancing Financial Stability ; First-Order Stake of EU Negotiators is Enhancing Financial Integration .	
Objective Function for Regulators	Objective Function for Regulated Institutions
<ul style="list-style-type: none"> ➤ Mission Fulfillment ➤ Reputational Standing of their Organization <ul style="list-style-type: none"> a. With clientele b. With National Politicians c. With Foreign Regulators d. With Taxpayer-Voters ➤ Personal and Career Benefits for Staff and Leaders 	<ul style="list-style-type: none"> ➤ Competitive Advantages, Including Loyalty of Clients and Broader Reputational Standing of Firm ➤ Regulatory Forbearances ➤ Personal Rewards to Staff & Leaders (Incentive Bonuses; Career Trophies and Opportunities)