NBER WORKING PAPER SERIES

BASEL II: A CONTRACTING PERSPECTIVE

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Working Paper 12705
http://www.nber.org/papers/w12705

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
November 2006

For valuable comments, the author is indebted to Richard C. Aspinwall, Rosalind Bennett, Fred Furlong, Richard Herring, Paul Horvitz, George Kaufman, John Krainer, Paul Kupiec, Geoffrey Miller, James Moser, and participants in research colloquia at the Federal Reserve Bank of San Francisco and the Federal Deposit Insurance Corporation. The views expressed herein are those of the author(s) and do not necessarily reflect the views of the National Bureau of Economic Research.

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JEL No. G21,G28,G33

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 theory of incomplete contracts to interpret the Basel Accords as a framework for continually 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. In the U.S., resolving these inconsistencies has complicated and markedly delayed Basel II's implementation.

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Revised November 13, 2006

BASEL II: A CONTRACTING PERSPECTIVE[*]

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This paper uses the concepts of regulatory arbitrage, sequential decision-making, and incomplete contracting to explain why the original 1988 Basel Accord (Basel I) and its successor Accord (Basel II) are better viewed as a collection of strategic guidelines than as a system of rules. This is because these 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.

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). But the success of their efforts is limited by the Accord's nonbinding nature and by divergences in stakeholder interests and political clout.

BCBS negotiations are founded on the premise that group expressions of regulatory intentions are something more than cheap talk. How much more is the ultimate

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issue. The Accord fails to include clauses that could make regulators in individual countries accountable for enforcing the standards it promulgates. Additional weaknesses exist both in the methods used to test Basel II proposals 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 demonstrates how a contracting perspective can help us to understand the protracted and sequential nature of Basel II negotiations and the weaknesses in regulatory accountability the Accord deliberately embraces. The analysis stresses the importance of nontransparent pre-Basel and post-Basel dealmaking between governmental and industry stakeholders in individual countries and the negotiating teams that participated directly in the Basel contracting process.

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 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 that leave contract terms incomplete. National regulators need these options to craft subdeals that are mutually acceptable to competing interests in their home counties.

Section II describes the particular options conveyed to banks and regulators in the Basel II agreement. Although few officials want 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 to explain how inconsistencies in the predeal understandings and goals of interested domestic parties are shaping post-Basel bargaining in the United States. Section IV identifies some possible paths for these negotiations. The path of least resistance may be for regulators to break 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 far 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 strategy-making process can be obscured by focusing only on the unsatisfactory nature of their 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)" is driven by the goals that stakeholders (S_{ik}) in each of m different countries(k = 1, …, m) hope to achieve from the process and the resources (R_{ik}) they plan to invest in lobbying for these goals. Stakeholders in each country k are indexed by i = 1, …, n_k. Using vector notation:

$$\text{Basel (T)} = \int_0^T B(t)dt, \qquad (1)$$

$$\text{Where } B(t) = B(\vec{S}_{1t}, \vec{R}_{1t}; \ldots; \vec{S}_{mt}, \vec{R}_{mt}). \qquad (2)$$

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, in most countries, the second and third pillars have been hollowed out by lobbying efforts and cannot support much weight. Until and unless the incentives of regulators are better aligned with those of ordinary citizens, Pillar 2 options are too feeble, too opaque, and too riddled with conflict from regulatory competition to reinforce either Pillar 1 or Pillar 3.

The result is that Basel II cannot bind national regulators to behave in globally appropriate ways. Rather, it sets the terms of a renegotiation game that merely asks officials to monitor and to think about the global consequences of actions taken by the institutions they regulate.

As mutable multinational agreements, the contracts the BCBS writes are first and foremost 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 we model as concerned sectors of each agent's home economy. Each

tentative contract that agents propose in Basel promises to pass a series of rights and obligations through to the negotiators' home constituencies.

Within a country's government, regulators are expected both to supervise and to represent conflicting constituencies. 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. We call these restrictions *predeal understandings*. Understandings are neither as sharply worded nor as enforceable as a formal contract. Because understandings are seldom made public, particular constituencies can interpret their understandings in ways that might well be inconsistent with one or more understandings furnished to another sector. Moreover, as parties with a personal and organizational interest in the game, negotiators may find it advantageous 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 other negotiators.

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

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 increasingly interested in promoting regulatory integration. Financial institutions hoped to redistribute safety-net costs and benefits among competing governmental and sectoral interests in advantageous ways.

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 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 future 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 the treatment of large and complex banking organizations. 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, loss exposures at large firms can easily be booked in ways that are too opaque for regulators to monitor and discipline them effectively. It is all too possible that data-collection and risk-measurement standards under Basel II are so badly specified that close adherence to them in making business decisions will result in an increase rather than a decrease in insolvency risk at many banks. To lessen this danger, capital requirements under Basel II ought to incorporate an additional transparency-related capital assessment designed to account for the option 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) by making its actions and motives transparent, bonding its commitment to the principal's interests, and 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 deterrent effects.

For every stakeholder (S_j, $j = 1, \ldots, n$), the value of each imbedded option k (O_{jk}, $k = 1, \ldots, m_j$) 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 only contingently accountable to voter-taxpayers for these omissions. Members were allowed to negotiate the agreement 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 stakeholder 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 regulatory standards and want to continue to advertise themselves that way. Second, any bank that found regulatory 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, banks generally support the effort to narrow this loophole by increasing the granularity of the risk categories used in setting capital standards.

Basel II does not differ from Basel I either in how it measures capital or in the arbitrary target ratios it sets. Besides increasing the number of risk categories, it 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.

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), 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 validate 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 using a single LGD for all of a bank's credits.

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 constructs this distribution is largely under its control. Because capital is costly, savvy regulators expect that most banks will use legitimate reporting options to understate their true loss exposure to some degree. However, regulatory protocols need to estimate how

fast the uncovered tail of the *true* loss distribution will grow when and as a bank's economic capital declines (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,…, 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.[1] 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 at 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

[1] The Fed's leadership role among central banks was inherited from Basel I. Throughout both processes, the Board and New York 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.

can persuade politicians and voters to examine and defend their stakes in the outcome if negotiations proceed badly enough for their side. 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, rules 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, these banks may reasonably think of themselves as too big to fail and unwind. In this case, tough rules would be undesirable because they would constrict a bank's ability to take tail risks large enough to shift losses onto 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 are unambiguously lobbying 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, they are bound to oppose adjustments that promise to increase the probability that a large institution might become economically insolvent.

In the predeal phase, U.S. regulators agreed publicly that very large U.S. banks[2] 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. A second predeal 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.

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

This 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 these conflicting promises, one Fed Governor – Governor Susan 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 was the understanding they sought.

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 their Basel II 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 serious gaps 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+ clienteles 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. Although not yet defined, 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 regarding the leverage ratio. 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 their 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 trigger could easily be hit in the second year, a 10-percent reduction is likely to be the recalibration target for which FDIC+ clienteles will threaten to lobby.

Undoubtedly, large-bank investments in risk-management systems promise a mix of regulatory and nonregulatory benefits -- not just regulatory ones. Still, by reducing regulatory benefits, this early rewriting of predeal understandings has reduced projected returns at large banks and thrifts and left the entire industry less trustful of the options they are likely to enjoy under the still-evolving regulatory system.

This summer, 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 are challenging his answer. To get large banks back on the train, the Fed may have to update AIRB design and can justify this as an effort to incorporate the most-recent advances in risk modeling. I suspect that, in commenting on the 2006 NPR, large banks may prove to have attractive alternative AIRB models to suggest. Since other U.S. regulators are in no hurry to adopt Basel II in any case, the main costs of reopening the AIRB plan 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.

To maintain financial stability, the choice of PCA triggers must feature the idea that declining accounting 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. These reviews publicly unveil a failed institution's supervisory history in excruciating detail. The credible threat of ex post accountability for imprudent forbearances greatly increases the incentive force that supervisors feel from PCA standards.

A dangerous path along which regulators might proceed would be to seek to bifurcate the inevitably politicized capital-assessment process in what appear to be sensible ways. If, in the distant future, risk measurement were reliably extended and improved, regulators might reasonably authorize the use of risk-weighting procedures for particularly well-capitalized banks. However, before the adequacy of regulatory capital could be safely defined by Basel-type risk-weighting procedures, these procedures need to be enriched by imposing substantial new allowances at least for the concealment options associated with the complexity of a bank's accounts and for its exposure to interest-rate risk. Even then, to counter nontransparencies in the forbearance pressures regulators experience, the simpler tests embodied in PCA thresholds must still be used to trigger regulatory discipline.

Whatever regulators decide about risk weighting, it is important that they strengthen leverage-ratio triggers for troubled banks and toughen risk-weighted calculations for all banks by changing the definition of capital. 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 would appear 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 regulatory capital set by Basel IA for community banks and by the still-to-be-determined large-bank options would each be calibrated to reduce regulatory capital to a level approaching the U.S. regulators' previously specified 10 percent threshold for redesigning the IRB option. If interagency negotiations force the FDIC to accept this outcome for minimum capital, the FDIC should use its authority to raise explicit deposit insurance premiums as a lever with which to persuade the other agencies to toughen PCA thresholds across the board.

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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

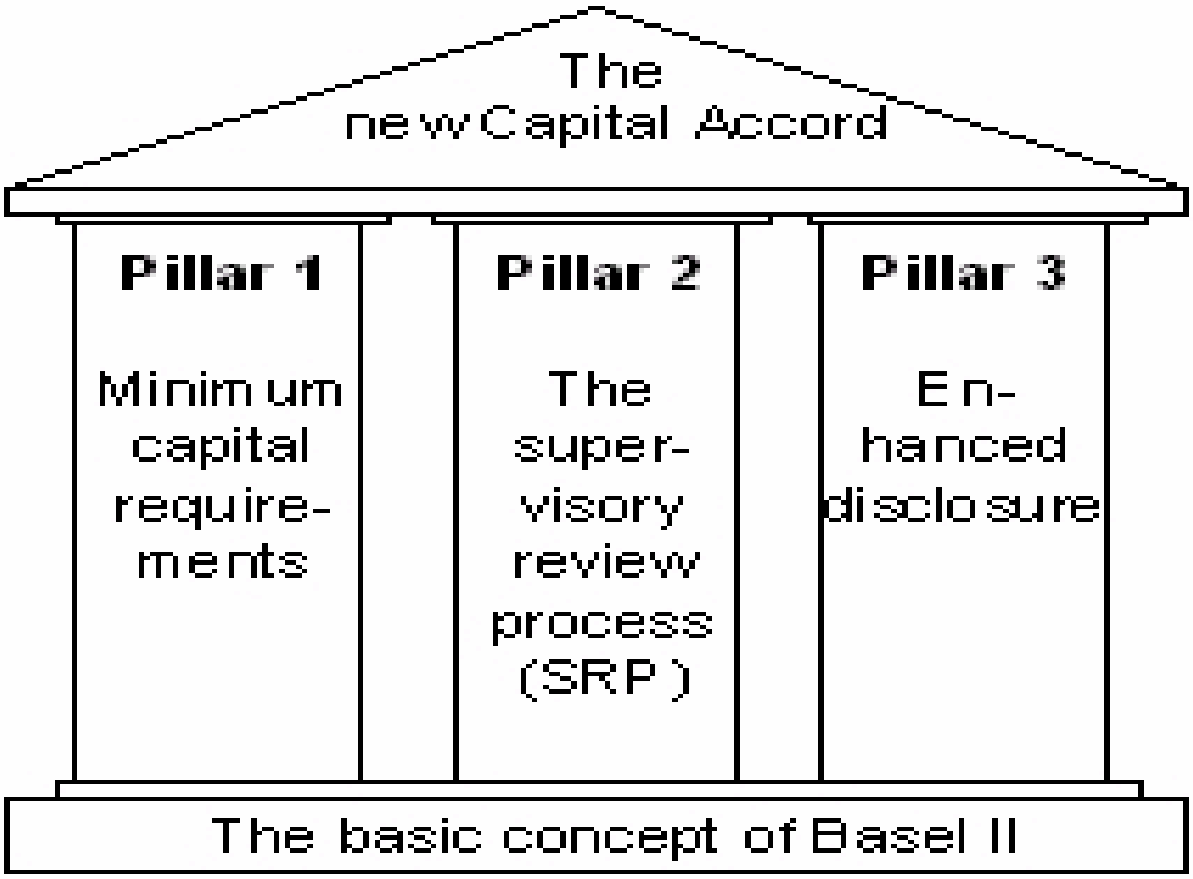
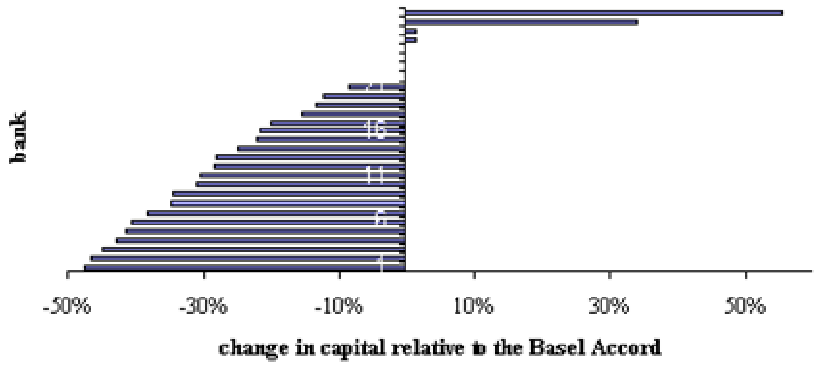

The new Capital Accord
Pillar 1
Minimum capital require-ments
Pillar 2
The super-visory review process (SRP)
Pillar 3
En-hanced disclosure
The basic concept of Basel II

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



Source: FDIC

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
  - William McDonough
  - Roger Ferguson
  - Susan Bies
- 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 (Uniformity Rather Than Financial 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 pol. and econ. 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**.

Sources of Welfare for Regulators	Sources of Welfare for Regulated Institutions
➢ Mission Fulfillment ➢ Reputational Standing of their Organization **a. With clientele** **b. With National Politicians** **c. With Foreign Regulators** **d. With Taxpayer-Voters** ➢ Personal and Career Rewards to Staff and Leaders	➢ 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)