Course title: International financial regulation

Lesson 4. Prudential Regulation of Banks – The Basel Accords

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BCBS and International Capital Standards

- Recognized expertise in banking regulation.
- Working groups of national regulators, which discuss the technical details of regulation and meet regularly.
- The final versions of the accords drafted by the Committee are eventually negotiated and agreed at the level of governors and chairmen of the supervisory authorities (or their deputies).
- BCBS does not have enforcement powers, it has implementation working groups that monitor how its capital rules are put into practice across jurisdictions.

Initially, the work of the Committee focused on promoting cooperation amongst banking supervisors, with a view to closing gaps in supervision (Wood 2005). Two basic principles informed the work of the Committee: no banks should escape supervision; and supervision should be adequate.

International Regulatory Tools

- Basel Accord I
  - Also known as “International Convergence of Capital Measurement and Capital Standards”
  - Dominated by the US.
  - Put in place after a series of banking failures in the US in the 80s due to low levels of capital held by banks.
  - Asked for higher capital requirements domestically.
  - There was an increase in Japanese banks in the US.
  - Hence, US policy-makers called for the introduction of risk-weighted capital standards internationally, with a view to creating a level playing field and protecting the competitiveness of their banking sector.

Story Repeats in the UK

- Like the US, the UK had been plagued by a series of domestic banking failures, the most well-known of which was that of Johnson Matthey Bankers Limited in 1984.
- British authorities also reacted by increasing risk-based capital requirements, which weakened the competitiveness of British banks *vis-a-vis* foreign competitors.
- Also worried about Japanese banks.
- The Anglo-Saxon alliance won over the Japanese authorities.

Basal Accord I

- Set capital adequacy standards for internationally active banks.
- Principally dealt with credit risk.
- Individual assets were divided into four basic credit risk categories (or 'buckets')
  - On the basis of the counterparty of each financial transaction;
  - Assigned weights ranging from 0 (loans to Organization for Economic Co-operation and Development (OECD) countries) to 100 per cent (corporate loans);
  - The sum of the weighted values of the individual balance sheet assets was classified as a bank's risk-weighted assets.

The Basel I accord was a non-legally binding gentlemen's agreement. Its rules became legally binding only when incorporated into the national legislation of the member countries.

Basel Accord I: Criticism

- The overarching criticism of Basel Accord I was that the rules devised to determine capital requirements were crude and potentially misleading.
- The method of calculation was risk-insensitive.
- Moreover, Banks had devised advanced credit management techniques which were rendered worthless.
- Hence, they lobbied for a better standard.

Basel Accord II

- Unlike the Basel I accord, which was largely based on the US regulatory template, the Basel II accord contained a new set of rules that were not from any national jurisdiction.
- Banks and Banking Associations had an active role in negotiations.
- The Pillar approach:
  - Pillar 1: Minimum capital requirements.
  - Pillar 2: Supervisory review process.
  - Pillar 3: Discipline imposed by the market.

All in all, the Basel II process began without any clear proposal from any country and was a collective effort by national supervisors and large banks to create a new paradigm for capital rules

Basel Accord II: Criticism

- European countries were apprehensive about the supervisory review process (Pillar II). They suggested the use of internal rating. Proposal was accepted.
- The use of internal ratings-based models by banks in order to determine their credit risk (Pillar I) was not received with much excitement and adversely impacted small banks.
  – Other changed were made to Pillar I when assessing Minimum capital requirements which watered down the standard.
- EU had a lot more at stake than the US.

Basel Accord III: One Last Attempt

- The Global Financial Crisis of 2008 restarted the discussion about global financial regulation.
- G20 exerted a lot of pressure along with G10 and banks.
- Proposed in 2009. Agreed rules will be phased in gradually from January 2013 until 2019.
- Built on Basel Accord II. Hence, path-dependent.
- Defined capital: The main form of 'Tier 1 capital' must be common shares and retained earnings.
  - The remainder of the Tier 1 capital can include subordinated debt.
  - This hurt European banks and reduced their capital base.

The original proposals for higher capital requirement were watered down in a search for a compromise between the US, the UK, and Switzerland, keen to set higher requirements, and continental European countries, resisting them and asking for longer transition periods.

(*Financial Times*, 22 Oct. 2010,13 Sept. 2010).

A LOT OF CRITICISM

- UK thought the capital ratio was not high enough.
- Governor of the Bank of France argued that the “diversified” and 'safer' continental European universal banking model should be dominant in the Basel Accord, rather than the 'risky' Anglo-Saxon originate-to-distribute model.
- German policy-makers, with some support from the French and Italians, were the most hostile to the higher capital requirements discussed during the negotiations and asked for an extended implementation period.

EU rules were primarily designed to foster integration in the banking sector rather than dealing with prudential issues.

In the negotiations for the Basel accords, the EU did not present a united front because its member states had different priorities, rooted in different structures of national banking systems and their links to the real economy.

Banking Advisory Committee

- Created in 1977
- Main forum in which banking legislation was discussed in the EU
- Met regularly but efforts not sufficient and slow.
- Major Actors:
  – National senior officials of Finance Ministries,
  – Central Banks, and Supervisory Authorities
  – Chaired by the European Commission

Lamfalussy Architecture

Baron Alexander Lamfalussy
Chair, Committee of Wise Men
(2001)

Level 1	EP and the Council co-decided framework legislati directives) proposed by the Commission.
Level 2	The implementing measures (generally directives, le regulations) of the level 1 framework legislation ado Commission.
	Comitology process: Involved the level 2 committee state representatives in banking, securities markets, and insurance.
Level 3	Committees of national regulators (level 3 committees) advised the Commission on the adoption of level 1 and level 2 measures and adopted level 3 measures, such as non-legally binding standards and guidelines.

1977

- Banking Advisory Committee to the European Commission (EC) created.
- Chaired by the European Commission. Included senior officials of finance ministry, central b authorities.

2001

- Lamfalussy Reforms adopted.
- Changed the Banking Advisory Committee to European Banking Committee.

2004

- Created the Committee of Banking Supervisors.
- Advises EC on implementation methods, issued standards and guidelines on decided practice supervisory cooperation.

2009

- European Systematic Risk Board established after the Global financial crisis.
- Changed Level 3 into independent authorities.

2010

- Committee of Banking Supervisors became the European Banking Authority.
- Coordinating the application of supervisory standards and promoting cooperation between na
- It develops technical standards, which are binding unless the EC opposes them.

Regulatory Tools used by the Banking Advisory Committee

- The First Banking Directive (1977)
  - Removed obstacles to the provision of (banking) services and establishment of branches across the borders of EU member states.
  - Harmonized rules for bank licensing.
    - Home Country Control: Financial firms could operate across the EU on the basis of rules set by the country where firm headquarters were located.
    - Mutual Recognition: All member states recognized the above principle.
- The Second Banking Directive (1989)
  - Established a single banking license—known as 'single passport'—that allowed banks to operate throughout the EU
  - Listed of banking services that could be provided in all member states on the basis of a licence.
  - Removed capital requirements at the branch level, but only at the bank level, to facilitate branching

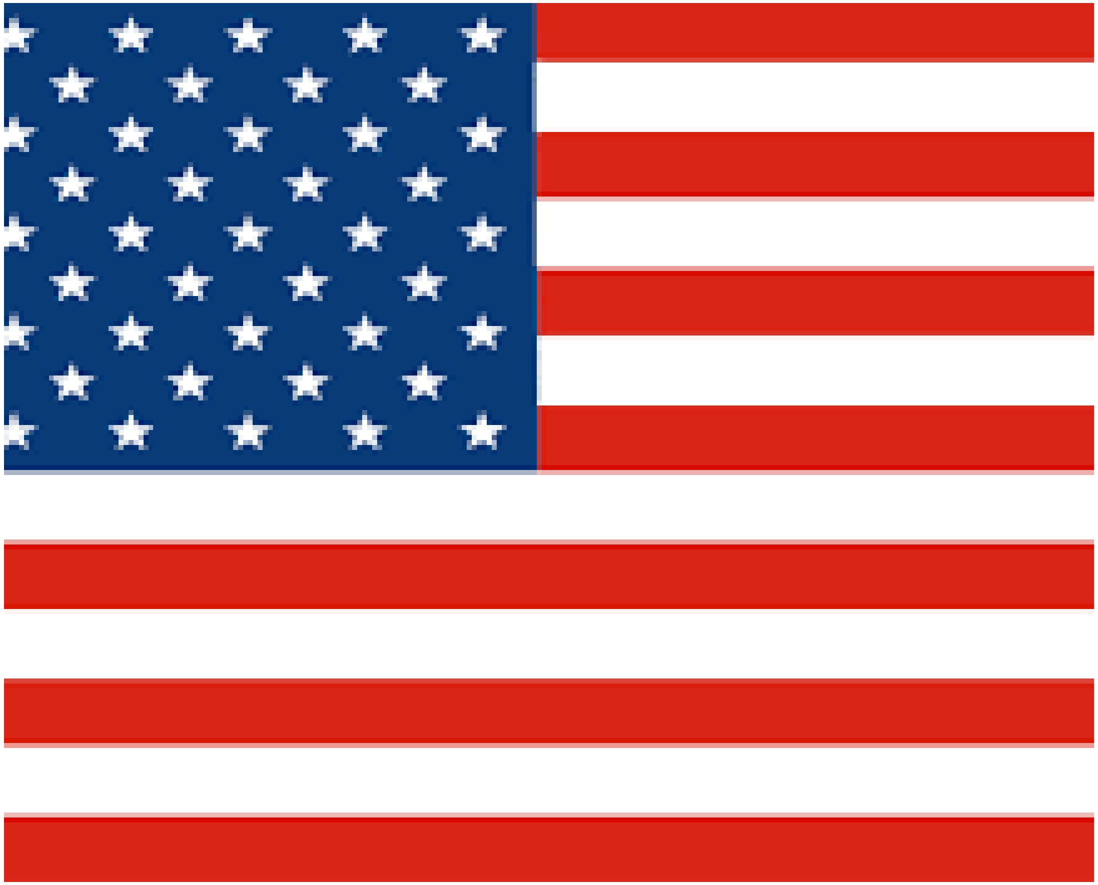
At that time, the member states had in place different national rules on capital adequacy and these rules mostly reflected the distinctive features of national banking systems, hence it was difficult for them to agree on a common set of prudential standards.

The Solution

- The Basel Accord I
  - Required banks to separate their ’Trading Book' from their ’Banking Book'
    - Own Funds directive (1989)
    - Solvency Directive (1989)
    - Capital Adequacy Directive (1993)
  - Difficulties in Negotiation
    - UK: Some observers regarded the British support for the Basel I accord as an attempt to prevent the establishment of distinctive EU rules with a strong continental imprint.
    - Germany: The largest banking sector in the EU and also has a distinctive three-pillared banking system, was a pace-setter in EU banking legislation from the outset.
    - The end result was in-line with what Germany argued for after the Second banking Directive was issued with Basel Accord I.

The (European) Commission acted as policy entrepreneur, but its efforts were very much directed towards promoting banking integration, rather than setting prudential regulation.

US banking regulation has evolved in a piecemeal fashion over time, largely in response to crises and policy failures.



US Regulatory Agencies

- The Federal Reserve Board
  - Has 12 state reserves as well.
- Office of the Comptroller of the Currency
  - Established by the National Currency Act (1863) and the Bank Act (1864) to supervise national banks.
  - A bureau of the Treasury Department.
- Federal Deposit Insurance Corporation (FDIC)
  - Supervises insured state-chartered banks that are not members of the Federal Reserve System, as well as state-chartered savings banks.
- Office of Thrift Supervision
  - Responsible for supervising federal savings associations and federal savings bank.

In banking regulation and supervision in the US, inter-agency competition has been frequent including during the negotiations of the Basel accords.

Regulatory Tools used in the US

- Dodd-Frank Act (2010):
  - Established a new Financial Stability Oversight Council, charged with identifying and responding to emerging risks throughout the financial system
  - Granted to the US Department of the Treasury, FDIC and the Federal Reserve new powers to close and wind down “too big to fail' financial (including non-bank) institutions in an orderly fashion.
  - The Federal Reserve was tasked with the supervision and regulation of all banks, thrifts, bank holding companies, and non-bank financial institutions with assets over $50 billion, as well as full authority to examine all non-bank subsidiaries of bank holding companies.

The Federal Reserve, which was the principal supporter of the Basel II accord in the US, recognized that 'creating international competitive balance under Basel II carried the potential that domestic competitive balance will become distorted'

(*Financial Times*, 5 Jan. 2004).

Dodd-Frank and Basel Accord I

- US regulators adopted risk-based capital requirements in 1986 (Kapstein 1989). These rules were then uploaded at the international level in the Basel I accord.
  - Common minimum fixed capital/asset ratio of 5.5 per cent for banks set at 5.5
- FDIC Improvement Act (1991)
  - Incorporated through Basel Accord I.
  - Passed at the height of the Savings and Loan Crisis in the US.
  - Introduced provisions on prompt corrective action by linking enforcement closely to the level of capital held by a bank.
    - Leverage Ratio: A risk-independent capital requirement that is proportional to the size of bank's assets

FDIC Improvement Act and Basel Accord II

- US authorities decided to apply the accord only to internationally active banks, which numbered approximately a dozen, with another dozen able to opt in.
- Rest still complied to a modified Basel I standard.
- Basel II was not implemented in the US because it was felt that the Basel II accord would disadvantage US banks domestically.

In the late 1980s, a combination of weak EU regulatory capacity and strong(ish) US regulatory capacity led to the uploading of US rules into Basel I, and the downloading of these international rules by the EU

The temporal dimension is important: the sequencing between the development of domestic regulatory capacity, to be precise the setting in place of robust domestic or regional regulatory templates and international standards, creates a process of path-dependence.

Many international political economy works consider the US as the dominant player in the making of rules for global finance because of its market size.

A large banking market, like that of the EU, is a potential source of power in international financial regulation. Despite the remarkable size of the EU banking market, the EU did not project a unified, common position during the Basel negotiations.

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