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CONNECTING NATIONAL SAFETY NETS: THE DIALECTICS OF THE BASEL II CONTRACTING PROCESS*

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Dialectics is the art or practice of trying to reconcile contradictory ideas. Contracting is a sequential process that employs the dialectics of multiparty give and take to fashion a deal that -- to a mutually acceptable degree -- can accommodate the contradictory interests of the dealmakers. The essence of contracting is to allocate a balance sheet of particular rights and duties to each counterparty. Whenever a contract assigns some parties options to reinterpret or breach their duties under unspecified circumstances, the contract is incomplete.

Basel II consists of a collection of strategic supervisory guidelines negotiated by representatives of central banks and national regulatory commissions that were members of the Basel committee on Banking Supervision (BCBS) in the decade leading up to June 2004. The BCBS developed as a cross-country regulatory response to the globalization of financial institutions and markets, which would otherwise connect national safety nets in an uncontrolled way. It meets on a regular basis to discuss emerging regulatory issues and to explore ways of harmonizing national standards for banking supervision.

It is fair to say that multinational banks are greater fans of harmonization than regulatory officials are. Banks see harmonization as a way to increase the efficiency of

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interbank competition by eliminating compliance burdens caused by divergences and duplications in national regulatory systems. Banks also view harmonization as a way to level the global playing field by making it harder for national governments to use their safety nets as mechanisms for delivering export subsidies to banking conglomerates headquartered in their country.

To model the stakes of the agreement, the paper conceives of a country's financial safety net as a social contract that generates net benefits and burdens for particular economic sectors. In linking country nets under Basel II, US regulators did not strike a deal with other BCBS members about how the new capital requirement system would apply to US banks.

Drawing on Kane (2007), this paper argues that participants in the BCBS process lacked sufficient democratic accountability to reconcile the fundamental conflicts between bank, regulator, and societal interests that arise in efforts to connect national safety nets. With respect to Basel II, recognizing how tightly the authority of the BCBS members is circumscribed by domestic politics explains three interesting puzzles:

1. Why Basel II authorizes individual countries to implement the agreement in markedly different ways;
2. Why the attempt to implement Basel II in the US proved so roiled with doubts, controversy, and delays that it fell far out of phase with Europe and Canada;
3. Why the debate over implementation waged between small and large banks and between the Federal Reserve and other US regulators [especially the Federal Deposit Insurance Corporation (FDIC)] proved unusually fractious.

Section I portrays Basel II as a problem in sequential contracting between short-lived agents and long-lived principals. BCBS members began by negotiating flexible predeal "understandings" with regulatory and banking interests in their home countries. Because some elements of the understandings contradicted the understandings of other domestic sectors, inconsistent promises had to be renegotiated during the post-Basel implementation process. Section II identifies inconsistencies in the goals and predeal understandings of interested sectors in the US and explains how these inconsistencies and turnover in regulatory personnel prolonged and empassioned post-Basel bargaining in the US. Section III explains how national differences in regulatory accountability made gaps in the cross-country deal more easily tolerated in other BCBS countries than in the US. Section IV argues that if governments ever want to establish a fully connected global safety net, they must make national regulators accountable to one another for the costs of not forcing undercapitalized institutions to cure capital shortages promptly.

I. Basel II As a Sequential and Incomplete Contract.

Each safety-net contract assigns rights and obligations to private and governmental regulatory bodies. To the extent that BCBS negotiations rework the rights or obligations of a country's regulators, they alter safety-net costs and the distribution of expected safety-net benefits across the sectors that regulators are responsible for.

The contracting process in Basel II unfolded in three phases: establishing flexible pre-Basel understandings between the BCBS members and domestic stakeholders; conducting cross-country negotiations between regulators in the BCBS; and negotiating a post-Basel reconciliation of differences between the BCBS agreement and stakeholder understandings. Contracting difficulties grow with number of agents and principals and

with the extent to which the interests of the various parties diverge. Both to cover their backsides and to minimize the discounted value of total contracting costs, it is desirable for agents undertake predeal negotiations with their principals. For this reason, one must assume that each important principal exchanged understandings directly and/or indirectly with its country's negotiating team. Principals include not only the top regulatory managers to whom negotiators report, but representatives of all interested economic sectors in each country.

Contracting theory presupposes that costs of reading and writing the terms of national safety-net contracts would be minimized (Hart and Moore, 1999; Macleod, 2006; Pattison, 2006; Rasmussen, 2001). To limit their reading costs, it is optimal for banks and other principals to place hard and soft constraints on the deals agents could make in the BCBS. We interpret these restrictions as predeal understandings. An understanding is vaguer and far more loosely bonded than a formal contract (cf. Hart, 2007). Because the text of understandings is seldom made public, constituencies can be encouraged or allowed to interpret their understandings in ways that might 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 be tempted to risk their reputation by accepting soft constraints on key issues that they hope subsequently to violate.

Different sectors differ in their ability to monitor regulatory performance and to enforce their rights. Realistically, under the safety-net contract, large banks have the strongest enforcement capacity and taxpayers the weakest.

Each understanding is meant to constrain the concessions that a particular sector may be asked to absorb. Because sectoral understandings are not made public, most inconsistencies did not have to be fully vetted until the equally nonpublic post-Basel "implementation" phase. To accommodate this third round of dealmaking, individual-country negotiators needed to incorporate numerous national design options into the cross-country agreements. National regulators sought at least some of this wiggle room to placate principals that might initially feel short-changed, aggrieved, or even betrayed by the cross-country agreement.

Because Basel I and Basel II are incomplete contracts, they establish a flexible structure within which to reconsider and renegotiate complicated cross-country relationships over time. But the immediate task of the options in initial design is to enable national regulators to craft subdeals whose distribution of burdens would be mutually acceptable to knowledgeable competing interests in their home counties. However, for regulators who made logically inconsistent promises to different constituencies, post-Basel contracting costs can be very high. When disappointed parties regard themselves as shortchanged, post-Basel negotiations are bound to become protracted and somewhat waspish in nature.

Figure 1 identifies the metaphorical "pillars" of the Basel II Accord. Although the diagram depicts the pillars to be of equal height and thickness, some important risks (such as interest-rate risk in the banking book) were left out of Pillar 1. Globally, the second and third pillars are hollowed out by national options, so that it remains to be seen how well they can handle crisis pressures. Pillar 2 options may prove too feeble, too

opaque, and too riddled with conflict from regulatory competition to reinforce the other pillars when and if a country's leading banks sink into economic solvency.

The Basel Committee's stated objective was to eliminate perceived cross-country competitive inequalities and to improve financial stability by promoting comprehensive risk management and consistency in regulatory standards across countries for multinational firms. BCBS agreements are not treaties because signatories represent regulatory agencies rather than sovereign governments. Individual negotiators and their superiors are short-lived agents for the long-lived domestic sectors they simultaneously supervise and represent. At many BCBS member agencies, top jobs turned over while negotiations were going on. Moreover, the number of seats at the BCBS table expanded during the process to accommodate umbrella financial-services regulators established by several BCBS countries.

II. Logical Inconsistencies in Pre-Basel Hopes and Understandings in the US

Basel I and II seek to limit safety-net subsidies by setting boundaries on the extent to which regulated institutions can leverage their balance sheets. The goal is to keep losses from spilling beyond a firm's internal capacity to bear losses by aligning its ownership capital with its exposure to economic loss. A commonsense analogy is an explorer's need to make sure that the caliber of his or her gun is large enough to handle the most-dangerous animals he might meet.

The linchpin of the Basel system is to measure loss exposure by the sum of risk-weighted assets (RWA). The weights employed in Basel I gave a bank no credit for the extent to which it might have diversified or hedged the risks in its loan portfolio. Nor did the formulas make any effort to account for operational or interest-rate risk. Finally,

Basel I failed to link the system of fixed risk weights it applied to particular assets to the average or marginal risk premiums that one could observe in loan markets. These disconnects artificially distorted patterns of bank risk transfer by creating opportunities for clever banks to capture safety-net subsidies by arbitraging the weighting system. The principal loophole was that, if and when regulatory demands for capital generated a compliance burden at a particular bank, its managers could eliminate the burden by selling or securitizing a sufficient amount of its least-risky assets.

These obvious shortcomings created widespread dissatisfaction with the status quo. Even though most banks continue to post a capital position far in excess of Basel I standards (suggesting that these minimum standards were not particularly burdensome), regulators were embarrassed by the size and perversity of the securitization and loan-sales loopholes. Although U.S. and foreign banks and regulators readily agreed that it was desirable to increase the granularity of the risk categories by which capital standards were set under Basel I, each sector hoped they could gain some incremental advantages from installing a more rational weighting system.

Small banks were concerned that existing arbitrage opportunities, while not very useful to them, were being exploited heavily by large-bank competitors. Many small institutions hoped that basing risk weights on external credit ratings would make it easier for them to improve their own risk management and would generate effective regulatory pressure on overly aggressive competitors as well. Small institutions were also assured that capital requirements would not be assessed against interest-rate risk in the banking book and that they would be exempted from efforts to account for operational risk.

Although US thrift institutions did not push for Basel II, they did not oppose it either. Their focus was on preserving or improving: (1) opportunities to take interest-rate risk and (2) the favorable weights that Basel I had assigned to home-mortgage loans. Trade-association leaders were confident that political pressure from the construction industry could help them achieve these results.

Most large banks already used sophisticated risk-management systems. Their primary goal was to lower their capital requirements by being allowed to generate their own diversification-adjusted asset weights based on their ability to demonstrate how the use of comprehensive internal models of loss exposure had helped them to hedge and/or diversify the default risk contained in individual positions. In contrast to the Basel I formulas, the position weights employed in these internal models would be formally linked to statistical risk premiums and external and internal credit ratings on various classes of loans. Implicit in this goal were two other objectives: (1) to persuade regulators to abandon their traditional obsession with the simple ratio of capital (K) to total assets (the "leverage ratio," K/TA) and to focus instead on the risk-weighted ratios authorized by Basel II; and (2) to prevent capital requirements imposed on US banks from constraining their ability to compete at home and abroad with foreign banks.

In developed countries, the market for financial regulatory services is highly contestable. For this reason, conflicts between the social missions of regulators and the interests of the sectors they regulate cannot be avoided. This conflict is intensified both by political and bureaucratic benefits that flow to regulatory bodies that please their clienteles and by reputational and career benefits afforded their leaders.

At every US regulatory agency, the vast majority of employees are involved in supervising and servicing an identifiable regulatory clientele. These operations create a bureaucratic interest in preserving the size and competitive positions of the sector they regulate. Nevertheless, officials cannot fail to recognize that neither Basel agreements deals with the practical difficulties of resolving the insolvency of a large and complex multinational firm. For this reason, although perhaps to a different degree, every agency ought to oppose post-Basel concessions that promise either to increase the probability that a large institution might become deeply insolvent or to delay the resolution of firms that fall into trouble.

In the predeal phase, U.S. regulators agreed publicly that very large U.S. banks would be required to use quantitatively advanced internal risk-based (AIRB) models of loss exposure[1]. Policymakers agreed at the outset that the reason for this mandate was to improve risk management at large banks, not to help these banks to operate with markedly lower levels of capital. Other institutions would be allowed to choose between the AIRB model and a "Standardized" more-granular extension of the Basel I system.

A second 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 (FDICIA) to supplement whatever use they make of risk-weighted measures of capital coverage, by a series of simple leverage-ratio triggers (measured by K/TA, i.e., capital divided by total assets) for Prompt Corrective action (PCA) intervention that are tough

[1] The mandate applies to banks or thrifts that have either $250 billion in total assets or $10 billion in assets held abroad. U.S. Office of Comptroller of Currency, et al. (Feb. 2007) explains what AIRB models entail.

enough and transparent enough to make top regulators and their staffs accountable ex post for losses suffered by the federal insurance fund. FDICIA designates the simple 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 of K/TA or K/RWA tripwires that require lesser interventions are set by interagency agreement.

Whether or not - as large banks hoped - regulatory use of the simple leverage ratio could be phased out proved a major sticking point in post-Basel negotiations. Perhaps because PCA requirements impinge on Fed independence, Federal Reserve personnel represented their concern for the leverage ratio as a "transitional" safeguard meant only to "backstop" Basel protocols for banks whose information or control systems might initially mishandle the complicated AIRB capital calibration. However, Congress and the FDIC held fast to the belief that the greater simplicity and transparency of a troubled bank's leverage ratio were needed to generate the personal and bureaucratic accountability that ultimately enables PCA requirements to restrain capital forbearance.

PCA obligations and inter-regulator understandings about the extent of capital reduction undermined predeal assurances that led the banking industry to expect that individual banks that designed and operated state-of-the-art risk-management systems would be rewarded with a reduced level of regulatory capital. In an offhand remark about the obvious conflict in understandings, a Fed Governor who was deeply involved in post-Basel dealmaking – Governor Susan Schmidt Bies – was quoted as saying, "The leverage ratio down the road has got to disappear" (see Heller and Davenport, 2005). The Fed's ability to deliver on this promise was blocked (at least temporarily) by the

outcome of the fourth Quantitative Impact Study (QIS4). QIS4 indicated that the 26 bank holding companies surveyed met only AIRB-generated requirements, 17 of them would show a leverage ratio that current PCA standards would classify as undercapitalized.

This result scared small banks, politicians, and the FDIC. It seemed as if quants at these 17 organizations used the QIS4 survey instruments to demonstrate to their superiors how effectively they could arbitrage Basel II restrictions on leverage without stopping to appreciate the danger of demonstrating this same capacity to Congress and regulatory clienteles in other industry segments. This supported the hypothesis that quantitative personnel at large banks and the Fed were driving the AIRB train in the U.S. and that disconnects existed in the way risk-management technocrats interfaced with the rest of their organization. Of course, neither the competitive upheaval nor the threat to the deposit-insurance fund that these results implied was sustainable politically. Small-bank and thrift-industry clienteles demanded that the formulas embodied in the Standardized Approach be recalibrated to afford them equal capital relief whether or not they actually improved their risk management. Either to placate small institutions or to scare them even more, a proposal was floated (and eventually abandoned) to adapt the AIRB approach to the capabilities of small institutions, which came to be known as "Basel IA."

In September 2005, the Fed and other federal regulators took what seemed like the first step in the post-Basel process of reworking their understandings about bank prospects for capital reduction. Regulators agreed that, during the first three years of implementation, no individual bank's Basel II capital requirement 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 assured one another 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.

Regulators' so-called "transition floor" proved unacceptable to large institutions and having to fight against it left the entire industry less trustful of the implementation process. All parties were annoyed that the time and resources invested in supervisory negotiations and bank measurement systems seemed to have produced an abortion.

In July 2006, four giant institutions – Citigroup, JPMorgan Chase, Wachovia, and Washington Mutual - turned on the regulators and openly demanded that large US 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 backed this play by formally asking "the agencies to permit U.S. banking organizations of all sizes the option of adopting alternative methodologies."

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 had spawned them. The banks also reasserted their claim that the provisions officials agreed to add to Basel II would convey unfair competitive advantage to foreign banks[2]. Finally, the four banks' February 2007 comment asked that the level of composition of the leverage ratio be reviewed at a future date.

[2] If true, the fault lies either in the procedures to validate IRB models in particular countries or in the absence of PCA requirements from Basel II (Nieto and Wall, 2006). Ironically European banks routinely express the opposite fear: that regulatory foot-dragging was generating an advantage for U.S. banks. They also complain that post-Basel negotiations within the EU have made little progress in narrowing burdensome home-host regulatory divergences.

On July 20, 2007 the regulators bowed to large-bank lobbying pressure by taking the 10% floor on capital reductions for individual banks off the table. At the same time, the Fed preserved its core demand that the nation's largest banks would be subject to yet-to-be-defined AIRB rules. The FDIC's concern for Basel II's impact on aggregate industry capital was reclassified as a matter to be studied during the transitional implementation period. It is stipulated that the final standards would be revised if "material deficiencies emerged during the trial runs."

III. Gaps in the Cross-Country Regulatory Contract

Contracting theory provides a framework for locating and identifying the explicit and implicit elements of any deal. Viewed as a social contract, every financial safety net includes three segments, every one of which maybe either explicit, implicit, or nonexistent:

1. Clauses that define and assign responsibilities for preventing disruptive financial-institution insolvencies.
2. Clauses that define a range of tax-transfer techniques for financing this supervisory activity and losses it fails to prevent.
3. Clauses that dictate the political and economic incentives under which safety-net operators discharge their responsibilities.

Using this perspective, Basel II may be seen to form a small part of a cross-country safety net whose second part is not yet even under construction. None of the clauses explicit in either Basel I or II address the issue of how taxpayers and surviving institutions might be assessed for damages that unlucky, negligent, incompetent, or

malicious regulators in on country might cause citizens or institutions located in other countries. The absence of this contract segment is instructive. It reveals the unwillingness of home-country governments to empower BCBS conferees to invest taxpayer resources in an explicit cross-country safety net.

What Basel II does explicitly assign national regulators is responsibility for monitoring and controlling insolvency risk at multinational financial institutions. This entails a further implicit responsibility for preventing such institutions from becoming insolvent. However, Basel II does not make regulators or anyone else accountable for minimizing the global or, more importantly, even the national costs of resolving the insolvencies that might nevertheless emerge.

In the U.S., the S & L insurance mess underscored the costs and dangers of capital forbearance. Now, US regulators are not only empowered, but required to insist that managers of any deposit institution nearing insolvency either recapitalize their firms or cede control of the firm to regulatory officials. In exercising this control, US officials are accountable for resolving the capital shortage of firms over which they take control at minimum cost to the deposit-insurance fund. Absent a voluntary recapitalization, resolution usually entails -- not the closure of the bank -- but its transfer to new owners (Kane, Bennett, and Oshinksy, 2007).

To wind up insolvent banks, European countries rely on ordinary corporate bankruptcy statutes enforced by their courts (Eisenbeis, 2006). This means that European regulators do not bear exclusive bureaucratic responsibility for controlling the subsidies that safety nets generate if and when troubled institutions are allowed to operate in an insolvent condition.

This paper argues that differences in accountability for the costs of capital forbearance between the Fed and the FDIC help to explain the difference in their expressed concerns about the importance of the leverage ratio. We concluded that these differences greatly prolonged the implementation process. In parallel ways, the less explicit accountability for the costs of capital forbearance that passes through to regulators in other BCBS countries helps to explain why post-Basel negotiations proceeded so much more smoothly in these venues.

IV. The Unfinished Task

Basel II is hard to understand and, where PCA requirements do not exist, it generates national options whose incentives support regulatory forbearance in difficult times. In a world of changing governments, it is impossible for one generation of regulators to craft a contract that can firmly precommit their successors. Besides their usefulness in conducting post-Basel negotiations with domestic sectors, the loose ends are designed to allow individual-country regulators enough flexibility to expand their catalogue of approved and disapproved behaviors over time as unforeseeable circumstances might dictate. In a world of changing financial technology, the list of contractable measures of instability can never be completely described. For both reasons, explicit contractual rights and duties must have slack built into them.

It must also be recognized that loose ends are reciprocal options that allow safety-net subsidies to be distributed nontransparently to private financial interests. Bureaucratic incentive systems tell us that the exercise of these options will be driven principally by the interests and global clout of the economic sectors to which national regulators are politically responsible. Hence, Basel II's most distressing loose end lies in

its failure to promulgate an accountable plan for promptly addressing capital shortages at large and complex banking organizations.

In every financial-center country, the largest institutions plan to compete as strongly as possible with foreign institutions. As long as they can reasonably believe themselves to be too big for authorities to fail and unwind, they have a strong incentive to resist efforts to fashion supervisory standards tough enough to preclude them from pursuing heavy tail risks that can extract taxpayer-contributed capital from the safety net.

Although some consultative papers address the winding-up problem, Basel II includes no specific plans for resolving large multinational financial organizations. This gap in planning engenders profitable opportunities for risk-shifting. The survival of these opportunities supports the hypothesis that the world's largest banks do not want a benchmark cross-country resolution protocol to be designed and tested. They must believe that, in crises, an environment of unstructured improvisation promises to enhance their ability to lobby for forbearances and/or to negotiate away their share of bailout costs if a large bank were actually to become insolvent.

Regulators' willingness to tolerate these gaps in Basel II suggests that both within and across countries, the key problem in controlling safety-net subsidies is to ensure that healthy institutions hold reasonable amounts of ownership capital. This suggestion is false because competitive forces give healthy institutions a strongly revealed preference for holding capital well in excess of Basel's minimum standards.

Instead, the central problem in financial regulation is to make sure that, even in politically and economically stressful circumstances, regulators have robust incentives to protect taxpayers by identifying troubled banks and forcing them to recapitalize before

their capital can become exhausted. To finish this job, a successor Basel accord will eventually have to benchmark the actions that home and host authorities should take when the capital position of an institution in their jurisdictions slips below acceptable standards and is not promptly replenished.

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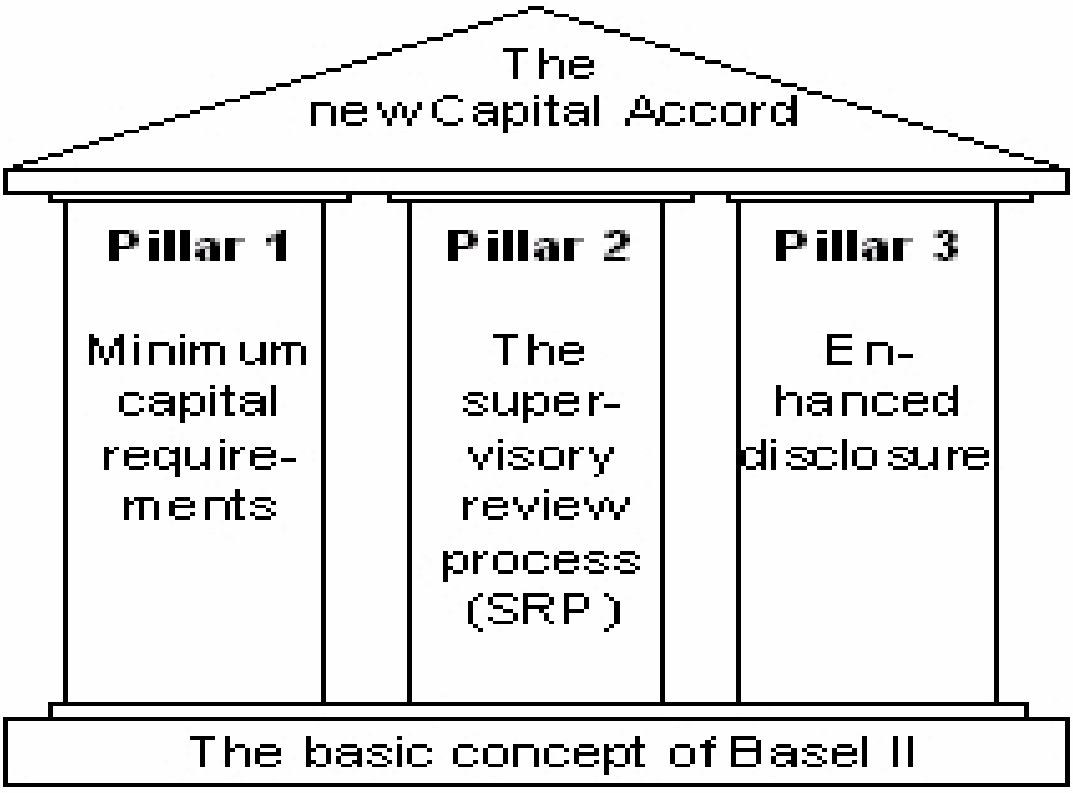

Figure 1. Metaphorical Representation of the Pillars Supporting Basel II