Third time lucky or out after three strikes?
The political significance of the Basel III
transnational standards for bank regulation

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A key feature of the official response to the 2007/8 financial crisis has been the effort led by the G20 to strengthen the transnational financial standard and codes that have been gradually developing since the 1970s. Some of the most important of these standards are those for banking developed at the Basel Committee on Banking Supervision (BCBS). A series of revisions to those standards that are central to the current regulatory response to the crisis, labeled "Basel III", were endorsed by the G20 leaders in November 2010. The supporters of Basel III hope that they will correct the deficiencies in the two earlier sets of Basel banking standards, but there are many skeptics.

Can the Basel III standards make a useful contribution to the prevention of future financial crises? Answering this question is useful for practical reasons, but also for the light it can shed on the capacities and limitations of transnational standards more generally. This question can be divided into two parts. The first concerns effectiveness: can transnational standards such as Basel III have any influence in a world of competitive sovereign states? The second concerns content: even if strong standards are fully implemented, will they serve the public interest and prevent crises, or will they instead be unduly influenced by industry and have different perverse effects, such as promoting the type of market conduct that contributed to the crisis, or preventing some more effective alternative regulatory change?

In addressing the first question there are helpful theoretical insights that have been developed in the literatures on global governance, global political economy, and the politics of transnational financial regulation. In a recent review of the strengths and weaknesses of this third literature, Helleiner and Pagliari have usefully identified three perspectives—one that emphasizes inter-state power politics and competition; one that stresses domestic factors; and one that focuses on transnational relations.[1] Helleiner and Pagliari then argue that "more effort should be devoted to the task of integrating insights from developments in all three of these political contexts" (p. 185). They begin to do this by setting out a strong case for the likelihood of "cooperative decentralization"—a shift towards transnational arrangements that allow or encourage greater variation across jurisdictions while managing some of the interdependencies that remain.

[1] Helleiner, Eric and Stefano Pagliari (2011) "The End of an Era in International Financial Regulation? A Postscrisis Research Agenda," *International Organization* 65, Winter, pp. 169-200.

In this paper I support Helleiner and Pagliari's call for an integrative approach, but contrary to their view that greater decentralization is likely, and to the view of those that see the primacy of inter-state or national political or commercial interests as precluding significant strengthening of the transnational regime for financial regulation, I argue that the dominant outcome of the crisis has been, and is likely to continue to be, a strengthening of the international standards regime and a reduction of variation across jurisdictions. With regard to the second question, I argue that on balance Basel III promotes the public interest rather than private interests, contrary to those who have seen the BCBS as captured by industry.[2]

The paper starts with a conceptual discussion that seeks to specify more clearly the factors that are likely to strengthen or weaken the ability of the standards regime to reduce variation across jurisdictions and how this relates to the problem of capture. It then turns to a more empirical assessment of the politics and performance of Basel III. Even though it is too soon to know with certainty how the response to the crisis will unfold it is useful to try to identify trends on the basis of the evidence available now.

Conceptualizing the political strengths and weaknesses of global banking standards

To assess the likely effectiveness of the standards it is useful to identify the factors that contribute to their power and autonomy, which can be derived from various perspectives[3], but especially transnationalist or institutionalist ones, and the factors that are likely to work against this power and autonomy, which are especially likely to come from national level influences, including those identified that focus on inter-state competition or domestic politics. To analyze transnational capture the most relevant approaches are the rational choice approaches that have most often been used to address capture, as well as Marxist and critical approaches that emphasize the broader structural power of capital and its influence in states and international

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[2] For analyzing capture the conceptual approach developed by Mattli and Woods is particularly useful. They take a process approach in which, rather the scholar seeking to define particular outcomes as in the public interest, particular conditions are specified that are likely to lead to regulation in the public interest rather than capture. They specify supply side conditions such as the inclusiveness, openness, transparency, fairness, and accessibility of regulatory institutions, and demand side conditions, such as the availability of information about the costs of regulatory capture, the presence of groups that can act as allies to the general public in holding regulators accountable to the public interest, and the emergence of ideas that can mobilize a coalition to promote the public interest in regulation. See Mattli, Walter and Ngaire Woods (2009) "In Whose Benefit? Explaining Regulatory Change in World Politics", in Walter Mattli and Ngaire Woods, eds., *The Politics of Global Regulation* (Princeton: Princeton University Press), pp. 1-43.

The following are particularly useful with regard to capture and global finance: Claessens, Stijn and Geoffrey R.D. Underhill (2010) "The Political Economy of Basel II in the International Financial Architecture," in Geoffrey R.D. Underhill, Jasper Blom and Daniel Mügge, eds., *Global Financial Integration Thirty Years On: From Reform to Crisis*. Cambridge: Cambridge University Press), pp. 113-33; Barth, James R., Gerard Caprio, Jr. (2006) *Rethinking Bank Regulation: Till Angels Govern* (Cambridge: Cambridge University Press); Baker, Andrew (2010) "Restraining Regulatory Capture? Anglo-America, Crisis Politics, and Trajectories of Change in Global Financial Governance," *International Affairs* 86(3), pp. 647-663; Lall, Ranjit "Reforming Global Banking Rules: Back to the Future?" ISS Working Paper 2010:6, Danish Institute for International Studies.

[3] On the approaches to financial governance see Helleiner and Pagliari, Porter, Tony (2005) *Globalization and Finance* (Cambridge, Polity); Porter, Tony (2010) "Finance" in Robert A. Denemark, eds, *The International Studies Encyclopedia*. Chichester: Blackwell Publishing, pp. 2254-73 and Blackwell Reference Online. 13 May 2010. On the transnationalist approach see also Tsingou, Eleni (2009) "Regulatory Reactions to the Global Credit Crisis: Analysing a Policy Community under Stress" in Eric Helleiner, Stefano Pagliari and Hubert Zimmermann, eds., *Global Finance in Crisis: The Politics of International Regulatory Change* London and New York: Routledge).

organizations. The transnationalist analysis of private authority can also be useful. The contrary influences that might offset capture can draw on transnationalist approaches, for instance identifying processes that Mattli and Woods have specified in offsetting capture, such as the dissemination of information, the activism of allies, or the creation of coalition-eliciting ideas can benefit from transnational activity. However states may be important in the accountability process too.

We may express this framework in a 2x2 table as in Figure 1:

Figure 1: Effectiveness and capture in transnational regulatory regimes

		Are transnational standards effective?	
		Yes	No
Is the transnational regulatory regime captured?	Yes	Strong captured transnational standards promote markets or business interests, as per rational choice and Marxist accounts	Business works at the national level to ensure that transnational standards remain weak, as per domestic politics view.
	No	Transnational standards generally promote the public interest, as per transnationalist approach	Public interest pursued at national level as per state-centric and domestic politics approaches

By integrating the questions of the power and autonomy of standards with question of whether they are prone to capture by business we can provide a better answer to the question of whether transnational standards like Basel III will make a future crisis more or less likely.

What factors might contribute to or undermine the power and autonomy of transnational standards?

The idea that transnational standards might have power and autonomy challenges some very well established conceptions of the way that international affairs and social life more generally operate. In the study of international affairs there are long established realist and positivist international law traditions that dismiss the importance of informal transnational standards such as those produced by the Basel Committee. Marxist approaches have often also seen rules as instruments of capital that do not possess any independent autonomy or effectiveness. More generally, many see the world as composed of self-interested actors that will only comply with rules if forced to do so. Since transnational standards setters do not themselves possess enforcement capacities it therefore follows that they cannot be effective. Skepticism about the power and autonomy of international standards is so well established that there is no need to summarize those arguments further here.

There are however a great many theories that suggest that transnational standards may enjoy power and autonomy. Some are quite close to more conventional approaches, such as the notion of agency slack in principal-agent theory. In this approach states remain dominant, but they are prepared to allow staff in international bodies to deviate from states' preferred policies if that cost is outweighed by the benefits from such delegation.[4] However others go well beyond traditional ontologies that see states or other self-interested actors, such as international officials,

[4] Hawkins, Darren G. et al. 2006. "Delegation under Anarchy: States, International Organizations, and Principle-Agent Theory," in Darren G. Hawkins et al, *Delegation and Agency in International Organizations.* Cambridge: Cambridge University Press, pp. 3-38.

as the constituent unit of international affairs. Rather than reviewing exhaustively or sequentially these very varied literatures it is more useful to extract from them four key factors that may contribute to the power and autonomy of transnational standards. These are (1) the constitutive role of ideas; (2) the reinforcement of the effects of ideas through their entanglement with material objects; (3) the importance of functionality; and (4) path dependence. It is useful to examine each briefly in turn.

There are a wide variety of theoretical approaches that have seen ideas as playing an independent role in governance. This includes very general approaches such as constructivism or Foucault's notion of governmentality, and more specific ones such as the concepts of epistemic communities or policy paradigms. In all these approaches actors cannot fully understand their interests or the problems they are challenged by without relying upon systematized ideas. The durability of these ideas can be enhanced by their intersubjective quality and the necessity of working with them to interact with others—the more actors that share them, the harder it is for any one actor to challenge or avoid them. Their endurance may also be reinforced by their internal consistency, the degree to which one idea builds on or is connected to another.

Ideas are further reinforced by their entanglement with material objects. This is especially evident with technological artefacts, such as a machine and its instruction manual that are the material expressions of a set of technical ideas, and which may interact in an ongoing way with the knowledge of the machine operator.[5] Analysis of material/ideational entanglements can be enhanced by insights from actor-network theory, which explores these entanglements at a micro-level, in extended networks.[6] These networks can be simply defined as identifiable patterns of interaction among humans and objects that make it possible for an action to be transmitted (not necessarily faithfully) one location to another. Such networks are relevant to the work of the transnational regulatory bodies. The ideas of regulators are not simply present in their minds or carried by their words, but instead are interacting with vast networks of humans and objects that extend far beyond the walls of their meeting rooms, such as computer networks or procedure manuals.

The third concept that is useful in considering the autonomy of transnational regulatory arrangements is functionality. This can be defined as the constraint that the pursuit of a particular purpose imposes on a set of actors and objects.[7] The constraints are perceived by actors or

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[5] Callon, Michel. 1991. "Techno-economic networks and irreversibility" in John Law, ed., *A Sociology of Monsters: Essays on Power, Technology and Domination*. London and New York: Routledge. 132-64.

[6] On actor-network theory see for instance Law, John and Hetherington, Kevin. 2000. "Materialities, Spatialities, Globalities," in Bryson, John, Daniels, Peter, Henry, Nick and Pollard, Jane eds. *Knowledge, Space, Economy*. London. UK: Routledge. pp. 34–49.

[7] This differs from an older discredited functionalism that was associated with post-World War II sociologists such as Talcott Parsons. That older functionalism was rightly criticized for seeing outcomes as caused by systemic imperatives, without explaining how latent functions were connected to the agency of individual actors, and without acknowledging the role of dysfunction, conflict, and systemic crises. In contrast, the concept of functionality used here assumes that functions arise from an interaction between human intention and the material constraints, which are not self-evident but are rather interpreted and contested. This overlaps with the notion of techne in philosophy, the meanings of which include the practical knowledge that allows an actor to bring something into existence. The notion can be agnostic on the degree to which functional constraints are due to the physical properties of objects or the interpretive beliefs of humans, and can involve a mixture of a logic of consequences and a logic of appropriateness. It can also be agnostic on whether the purposes are devised by the constrained actors or by their collective role in a larger environment. This notion of functionality is not incompatible with the varying constraints associated with different games in game theories. It is also not incompatible with Luhmann's claim that a functional response to complexity is to create a specialized organization or system of communication that selects and processes particular types of information or objects, exchanging these with its environment. This system of communication,

observers as imposed by a purpose that the actors may wish to pursue. With regard to transnational regulatory networks, the influence of functionality is evident in the degree to which debates are framed and actions taken with reference to shared purposes such as promoting financial stability or capital adequacy, rather than, for instance, negotiated compromises between national interests.

The fourth concept that is useful in considering the autonomy of transnational regulatory arrangements is path dependence. Pierson usefully goes beyond vaguer notions of path dependence to emphasize the way that positive feedback and the impact of sequencing contribute to path dependence; and how when combined with the very slow character of many significant changes this reduces the ability of actors to *choose* and shifts our attention to how institutions *develop*.[8] Pierson encourages us to integrate an analysis of larger epochal historical changes with the histories of more specific social *mechanisms*: "limited generalizations—that can 'travel' in some form beyond a specific time and place" (p. 6). This interaction between large slow changes and specific mechanisms can help explain how transnational standards setting processes like the BCBS's can enjoy power and autonomy: agency is expressed through specific institutions, but these institutions are built over long time periods and do not easily change. This analysis of path dependence is greatly enhanced by sensitivity to the entanglement of ideas and materiality that was discussed above. At the global level the embeddness of ideas and practices, for instance in electronic networks, policy documents, and meeting venues reinforces this path dependence.[9] The Bank for International Settlements, which hosts the BCBS and most other transnational bodies, has been carrying out this function in its offices in Basel since the 1960s, and when viewed from this longer perspective the standards bodies display a consistent incremental pattern of growth, development, and integration since that time.

How might we assess empirically the significance of these four factors contributing to the power and autonomy of transnational standard setting and weigh then against the more traditional power and autonomy of states? The following can apply to transnational rules of any type. They can indicate whether the factors favoring the power and autonomy of those rules are present:

1. Ideas associated with the rules are complex and interconnected making them difficult for any individual actor at any particular time to abandon or change.

2. Ideas and rules are embedded and entangled with material objects that extend well beyond those developing the ideas and that don't match up well with state boundaries.

3. Debates are framed with reference to functionality rather than national interest and these match up with the incremental development of ideas, rules and institutions noted above, rather than a sequence of loosely connected bargains.

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with its distinctive language and codes, can create the type of autonomy that Luhmann labelled *autopoiesis.* See Luhmann, Niklas,. 1982. *The Differentiation of Society.* New York: Columbia University Press). For functionality in finance see Porter, Tony, (2003) "Technical Collaboration and Political Conflict in the Emerging Regime for International Financial Regulation" *Review of International Political Economy*. 10(3), August, pp. 520-51.

[8] Pierson, Paul (2004) *Politics in Time: History, Institutions, and Social Analysis* Princeton: Princeton University Press.

[9] Porter, Tony (2007) "Compromises of Embedded Knowledge: Standards, Codes and Technical Authority in Global Governance" in Steven Bernstein and Louis W. Pauly eds., *Global Liberalism and Political Order: Toward a New Grand Compromise?* Albany: SUNY Press), pp. 109-131.

4. Ideas, rules and institutions display incremental development over long periods of time, rather than a series of changing configurations reflecting the shifting distribution of power or interests across states.

Is the rulemaking process captured by industry?

How can we know whether powerful autonomous standards will actually constrict the pathological behaviour of banks rather than promoting it, perhaps by forestalling stronger standards? Two questions are useful in knowing whether the process is captured or if it instead will promote the public interest in financial stability:

1. How prominent is business in the four processes that indicate the likely power and autonomy of transnational standards relative to actors other than business? If business is prominent capture is more likely.

2. Is there evidence that transnational standards are difficult for the industry (indicating a lack of capture), and if so is the industry successful in reversing them (with a reversal indicating capture)?

I turn now to an examination Basel III in which I seek to assess its usefulness in preventing future crises while making reference to the factors that I have suggested are relevant to the question of their power and autonomy, and whether they are captured.

Basel III

This section starts with a brief overview of the history and main features of Basel III before analyzing its significance.

Main features of Basel III and its antecedents

Basel III builds on the two previous capital adequacy agreements developed at the BCBS. The first 1998 Basel Accord first established agreed standards for bank capital adequacy, specifying the amount of capital banks needed to hold against their risk-weighted assets. This was designed to rein in excessively risky expansion of bank lending while offsetting the downward pressure on standards through coordinated implementation in all the jurisdictions of the BCBS member-states, together constituting most global markets. At that time, and until 2008, the Basel Committee membership was restricted to regulators representing twelve of the countries with the largest banks. Most other jurisdictions also adopted the standards, encouraged by market pressures favouring adequately capitalized banks, and by peer pressure exerted through a set of regional bank regulatory bodies associated with the BCBS.

For its time the Accord was an unusually complicated agreement to jointly alter the regulation of international banks. However it soon was seen by the industry and regulators as too simple for the multiple complex risks that banks were managing, and in response a long process of revision was launched, culminating in a far more detailed Basel II Accord that was agreed in 2004 and was in the process of being implemented when the 2008 crisis began. Noteworthy new features of Basel II included rules allowing banks to use their internal risk models in calculating their required levels of capital, new charges for operational risk, and a new reliance on credit ratings in the assessment of the riskiness of assets. There was strong debate about whether Basel II had contributed to the crisis. Its defenders pointed out that it had not been fully implemented, while its critics argued that its provisions would have either failed to address some key factors contributing to the crisis (such as its failure to regulate the "shadow banking system") or even have exacerbated the crisis (such as its "procyclicality"—its tendency to force banks to cut back lending in bad times and allow them to expand further in times of excessive expansion of credit).

As the 2007/8 crisis unfolded, like all the transnational financial regulatory and standards bodies, the BCBS adjusted and added to its workstreams in response to directives from the G20 and its own assessments of the changes that were needed. Rather than entirely abandoning Basel II, as some critics would have preferred, the G20 and the BCBS instead set about to correct its problems and develop it further to address additional risks that had become evident during the crisis. The package of measures that resulted was labelled Basel III. While the key features of Basel III were agreed and approved by the G20 meeting in November 2010, there are important additional closely related standards, some primarily being developed by bodies other than the BCBS, which were not finished by that date.[10]

The main features of Basel III include more stringent and clearer standards on what would be allowed to count as bank capital, a simpler leverage ratio linking assets and capital to offset the complexity of Basel II, stronger liquidity requirements, to prevent the evaporation of liquidity that had occurred during the crisis; and new rules to begin to integrate the shadow banking system that had developed around securitization. These last, for instance, included requiring banks to hold capital against risks in their trading books and risks associated with the quasi-independent entities created by banks to produce securitized debt. Basel III also initiated the use of capital buffers to work against the procyclicality of Basel II. If banks do not maintain the specified buffer they will be subject to restrictions on their ability to pay out bonuses and dividends. In good times regulators can increase the buffer on all the foreign and local banks operations in their jurisdictions. Once authorized by regulators at the onset of crisis, the buffers will be released to help the banks avoid distress or restrictions in lending. The BCBS has developed indicators based on the credit/GDP ratio to indicate when buffers need to be expanded to restrain overly exuberant lending, an important part of a new interest in "macroprudential" issues in addition to the more traditional micro-prudential focus on the health of individual banks. The Basel III measures are to be phased in on varying time frames, with some key aspects due only in 2019. Important and closely related work that is ongoing at the BCBS and other bodies, including especially the Financial Stability Board (FSB), includes the specification of criteria for global systemically important financial institutions (G-SIFIs), the procedures for shifting over-the-counter (OTC) derivatives markets to exchanges and central clearing parties, reducing or eliminating reliance on credit rating agencies in assessing regulatory risk weights, and further development of "living wills" (where banks are required in advance to produce plans to more easily wind them down if they become insolvent during crises) and other cross-border insolvency practices.

[10] Details of Basel III and related measures can be found on the BCBS and FSB's websites.

Analysis: how autonomous and powerful are the Basel III standards?

As suggested above, some observers would immediately dismiss the relevance of Basel III standards on the basis of their belief that national power and interests will always trump international rules, particularly ones like Basel III, which take the form of soft law rather than formal ratified treaty law. To the degree this is based on untestable and unfalsifiable assumptions about the enduring character of international relations, it is an article of faith rather than a theory or proposition that can be challenged by arguments or evidence, and there is no value in engaging with it other than to treat it as a background reminder to consider state power in more nuanced or empirically-oriented analysis.

For those interested in a more integrative approach open to revision on the basis of evidence, there are still serious questions about the ability of Basel III to overcome the challenges of a competitive sovereign state system. Helleiner and Pagliari have identified a number of such questions. National political authorities, including legislators, became much more concerned with the transnational arrangements during the crisis, and this is likely to continue as citizens are asked to pay taxes or endure service cutbacks to pay for the crisis. During the crisis the membership of the BCBS and other similar bodies was expanded to match more closely the G20 membership, and this brings very different national systems into the standard-setting regimes, making consensus more difficult with the addition of powerful new actors like China. Differences across jurisdictions in their experience of the crisis have exacerbated longer standing differences across varieties of capitalism. The unified transnational private sector voice that had complemented and reinforced official transnational collaboration may break apart with the growing influence of new actors, and because of intra-industry conflicts provoked by the crisis. The shared market-oriented and technical intellectual consensus, the “ideational cement” (Helleiner and Pagliari 192), which enhanced collaboration before the crisis, has been severely damaged. These characteristics of the post-crisis are key to Helleiner and Pagliari’s argument that a transnational regulatory regime which permits and promotes more fragmented decentralized variation across jurisdictions is a likely outcome of the crisis.

In order to assess the likely consequences of these challenges to transnational standard setting it is useful to consider the four factors that reinforce the power and autonomy of standard setting that were set out above. Analysis of these four factors can help in knowing whether the pressures towards fragmentation are offset by pressures that maintain or strengthen the uniformity and strength of transnational standards.

The first factor was whether ideas associated with the rules are complex and interconnected making them difficult for any individual actor at any particular time to abandon or change. This is especially relevant to Helleiner and Pagliari’s view that the ideational cement holding the regime together is dissolving. It is certainly the case that an older consensus in favour of light regulation has been replaced by a more vigorous debate about the merits of measures, like rules on executive compensation, that would have been seen as inconceivably interventionist before the crisis. However, when it comes to the application of ideas in regulatory contexts there is a remarkable degree of continuity and consensus. This is especially evident in the enthusiasm for using incentive-based risk sensitive measures that involve an incremental increase in the accountability of states to each other, and an incremental increase in the minimum acceptable setting of the standard.

All the elements of Basel III reflect this. The strengthening of the definition and level of capital is a significant but incremental change to Basel II. There are two new liquidity standards.

The first specifies the amount of liquidity banks need to retain over the coming month. The second is a longer-range standard addressing the relationship of the maturity of assets and liabilities (if liabilities like deposits and short term and assets like loans are long term this can be a source of liquidity problems). Both give significant discretion and flexibility to banks in determining how they meet these standards, but both also set limits around the amount of liquidity risk the banks are allowed to take on. Rather than breaking up banks that are "too big to fail", as some observers recommended, the emerging consensus on G-SIFIs is again a risk-based relatively decentralized measure that sets a threshold above which banks will be scrutinized more closely and will have to hold more capital. The buffer, the added capital that will be required for trading non-standard derivatives elsewhere than exchanges and central clearinghouses, and the measures taken to bring the shadow banking system into the regulatory regime all resemble one another in not outright prohibiting activities but rather imposing higher capital charges on those deemed to be riskier. These all reflect similar ideational qualities in using rules to the minimum extent needed to correct incentive problems that exist in markets: they are all consistent with rational choice political economy approaches dominant in fields such as the new institutional economics or law and economics. They all focus on risk models. Because they all refer to risk, and often to capital, they are commensurable: the firm's total risk exposure and capital adequacy can be related to each element of Basel III. This makes it difficult to propose alternatives. Examples of alternatives, such as bank taxes, breaking up banks seen as too big to fail, or the separation of deposit taking and investment banking activities, have not made it on to the international agenda. The approach of the Basel Committee has not changed and the ideational conflicts that Helleiner and Pagliari rightly identify take place almost entirely outside the regime itself, which retains its ideational glue. Especially as the crisis has receded, the conflicts are mostly about the calibration of the regulatory instruments, not what the goals should be, or even whether the types of instruments used are the proper ones.

The second factor was whether ideas and rules are embedded and entangled with material objects that extend well beyond those developing the ideas and that don't match up well with state boundaries. There is considerable variation across financial sectors in the way in which ideas and rules are entangled with objects. The strongest entanglements are evident in the effort to move OTC derivatives trading onto central counterparties (CCPs). These foster transparency and stability by routing trades through a single system with margin requirements and other rules, as well as the capacity to reduce exposures by only transferring the net differences in a series of trades. The OTC Derivatives Regulators' Forum (ODRF) met with the world's top CCPs to move this process forward on November 2, 2010.[11] Once fully established the new arrangements will rely heavily on the CCPs' technologies, which have a strong material component, involving a degree of automation and high sunk costs. CCP technologies do not match up with national borders, although the persistence of inter-state competition was evident when a 2009 merger proposal between DTCC (which originated in the US) and LCH.Clearnet (which originated in London) failed, in part because of European political and regulatory opposition to such a US presence in European clearing.[12] More generally, the implementation of both Basel II and Basel III require very substantial investment in new risk management capacity by banks subject to it.

[11] Meeting between OTC Derivatives Regulators Forum (ODRF) members and representatives of central counterparties (CCPs) and trade repositories (TRs) November 2 - 3, 2010, at http://www.federalreserve.gov/newsevents/files/ODRF_meeting_20101102.pdf, accessed May 6, 2011.
[12] "DTCC scraps LCH.Clearnet merger talks," April 29, 2009, *Reuters* http://uk.reuters.com/article/2009/04/29/uk-dtcc-lchclearnet-idUKTRE53S7F620090429, accessed April 24, 2011.

Although some of these investments have immediate value for the banks in helping managing risks that they would want to manage independent of regulatory requirements, others do not. An assessment of the precise magnitude of these costs is not available, and would be useful to obtain, but it seems highly likely that the central features of Basel II and III, once implemented in the routines, policy and procedure documents, computer systems, and practices of bank staff around the world, will be very difficult to reverse.

The third factor was whether debates are framed with reference to functionality rather than national interest and whether these match up with the incremental development of ideas, rules and institutions noted above, rather than a sequence of loosely connected bargains. A strong functional orientation has been a long-standing characteristic of the Basel Committee's work. National interests are certainly expressed. For instance Denmark initiated a very strong campaign against the Basel III liquidity requirements because it happens to have a very successful covered bond market that finances mortgages, and the liquidity requirements restrict reliance on covered bonds. This campaign was joined by France and Germany, which also rely on covered bonds to a significant degree. However this dispute is not framed at all as a competitive one involving a negotiation between national interests. Instead it is treated as a technical problem for which a solution will probably be found. Danish covered bonds have been remarkably stable since the beginning of the crisis, and thus there are strong arguments on systemic stability grounds for making an exception for them.[13] The predominant emphasis in Basel Committee documents is on the functionality of the agreements, with almost no mention of national conflicts. If the regime was fragmenting one would expect to see such national conflicts become a more explicit focus of Basel III documents and discussions.

The fourth factor was whether ideas, rules and institutions display incremental development over long periods of time, rather than a series of changing configurations reflecting the shifting distribution of power or interests across states. If we observe the longer history of transnational financial regulation beginning with its origins in the 1970s there is remarkable continuity up until the crisis of 2007/8. These decades saw the establishment of a series of very similar informal regulatory bodies consisting of officials from countries dominant in global finance meeting periodically, assisted by secretariats mostly hosted by the Bank for International Settlements. Over time the number of these bodies grew to address new issues, and the interconnections between them grew as well. Over time their political oversight developed as well, as first the G7 and then the G20 began more actively to provide guidance and endorse their projects. The creation of the G20 and the Financial Stability Forum in 1999, in the wake of the East Asian financial crisis, was a significant step in this long process, but an incremental one, that built on the practices and institutions that had developed over the previous quarter century.

A remarkable feature of the response to the 2007/8 crisis was the degree to which it too built incrementally on the existing institutions and practices. Rather than creating an ambitious new World Financial Organization, or returning to national solutions, the initiatives simply strengthened and added to existing work programs. The G20 was elevated to a leaders' level summit; the regulatory bodies were expanded to match the G20 membership; the Financial Stability Forum was modestly formalized and given a peer review function and a new name, the Financial Stability Board. Each of the standard setting bodies added new elements to existing work programs. This is evident with Basel III, which build on Basel II and other work that the

[13] Brogger, Tasneen and Jim Brunsden (2011) "Germany, France Join Denmark to Fight Basel Liquidity Rules," *Bloomberg* http://www.bloomberg.com/news/print/2011-03-09/germany-france-join-denmark-to-fight-basel-liquidity-rules.html, accessed May 6, 2011.

BCBS or other bodies had already initiated, including liquidity standards and cross-border insolvencies. More novel features of Basel III, such as the counter-cyclical buffers, fit closely with the type of approach already evident in the BCBS work, as noted above. This type of incrementalism is evident across the other bodies as well. It is present both in the organizational features of the regulatory bodies and in the degree of complexity and harmonization in the standards themselves.

Is this type of incrementalism likely to be reversed? Helleiner and Pagliari suggest that it is. Certainly G20's incentive for collaboration from the fear of global collapse has waned relative to the height of the crisis. However on the regulatory program the predominant tendency is the continued incremental forward movement. The implementation of Basel III has been stretched out much longer than many would have preferred, and there were issues such as the G-SIFIs, the CCPs, or role of credit rating that were not finalized by November 2010 when the main Basel III package was endorsed by the G20. However each of these other work programs has not been abandoned or tabled, as one would expect if decentralizing forces were reversing the regime's trajectory, but rather are proceeding in a manner not inconsistent with the time needed to work out some very complex technical issues. As noted with the Danish covered bond example above, the obstacles that are arising may be treated as complications that require relatively inconsequential adjustments in a set of overall rules that are strengthening and becoming more standardized. For instance, after being widely criticized for conducting excessively weak stress tests in 2010, EU regulators initiated a new and tougher set of stress tests in 2011.[14] The peer review processes conducted by the FSB, which by their very existence provide a new reinforcement to the regime, also confirm that while the pace of implementation varies significantly across countries the overall theme is the commitment of countries to implement the standards.

While the change in players associated with the alteration of the regulatory bodies' memberships to match the G20's certainly complicates decisionmaking, the newer players can have many of the same interests in global standards that the old players had. China, for instance, is aggressively implementing Basel III ahead of the required schedule.[15] Liu Chunhang, Director General of the Policy Research Bureau and Statistics Department at the China Banking Regulatory Commission, stated in 2011 that "effective financial regulation today requires intense collaboration amongst national regulators not just in setting standards but also in daily supervision. We have seen important improvements in this area in recent years." While noting the difficulty of addressing differences in financial structures, he went on to say "Despite these difficulties, important consensus has emerged from recent discussions amongst regulators in a number of areas…Regulators around the world are increasingly speaking the same language in terms of prudential standards and best practices in supervision… policymakers should not be swayed from the general direction of financial reform undertaken so far."

Liu Chunhang also notes that "sufficient attention must be paid to the power, resources and governance of financial regulators and supervisors."[16] Ironically it has been reported that US regulatory agencies are drastically under-funded for the tasks they have been assigned by the

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[14] Cordes, Renee (2011), "European banks brace for tough stress tests," *Daily Deal* April 8, Accessed through LexisNexis.
[15] "Stricter Bank Rules Will Take Effect In Early 2012 CBRC", May 4, 2011; Liu Chunhang "Financial Regulation Essential," Chinadaily.com.cn, February 16, 2011, Chinadaily.com.cn, accessed through LexisNexis.
[16] Liu Chunhang "Financial Regulation Essential," Chinadaily.com.cn, February 16, 2011, Chinadaily.com.cn, accessed through LexisNexis.

Dodd Frank Act, and the House Republicans are eager to cut their budgets further.[17] Regulatory capacity is a key feature of the Basel Core Principles for Effective Banking Supervision, originally targeted at developing countries. However should the US fall short of these standards it is highly likely that countries like China, which are heavily exposed to the risks associated with US laxity, will continue to be positive about using Basel III and the standards regime more generally to hold their other G20 partners more accountable. It should also be noted that the personal interests of regulators themselves in countries such as China where the state is more dominant may be more focused on building the budgets and capacities of their agencies, rather than weakening the agencies with an eye to a profitable future position in the private sector, as many suspect is the case in the US.

Some remain frustrated at the degree of US-EU differences in implementation. For instance Wolf Klinz, head of the European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS) noted the difference in process in Washington (one big Act at once) and the EU (working through one topic at a time), and complained that "even though the G20 first met in Washington two years ago to say that every product, participant and jurisdiction would be regulated along the same lines, this has not happened… In most areas, we have partial convergence with the US, but we have not a single area where we say it's identical."[18] In general the EU approach is stricter, and this caused particular tensions with the US on the diverging approaches to hedge funds.[19] A particular concern is that the US Dodd-Frank Act banned references to credit ratings in regulation, while Basel III continues to rely on them, and there were fears expressed in early 2011 that the US would consequently be unable to implement the liquidity provisions of Basel III.[20] It is noteworthy, however, that the Dodd-Frank Act, despite the intensely partisan character of its negotiation, left the specification of bank capital adequacy to the Basel Committee rather than trying to legislate in this area.

Looking at these four factors overall there is good reason to expect Basel III and the larger regime of which it is a part to continue to move forward in an incremental manner, increasing the strength and uniformity of the standards, rather than managing fragmentation and decentralization. This does not mean that conflicts and complications will not arise—their presence is an indication of the need for a regime rather than a less institutionalized process of harmonization. However the presence of these risks does not negate the incremental strengthening of the regime as a whole. There is also a risk that industry lobbying will defeat the reform initiatives, an issue that is addressed in the next section.

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[17] Protess, Ben (2011) "U.S. Regulators Face Budget Pinch as Mandates Widen," *New York Times*, DealB%k, May 3, accessed through LexisNexis.

[18] Collins, Sarah (2010) "Interview with MEP Wolf Klinz, Chair of EP's Crisis Committee: EU-US Divide over Financial Regulation Persists," *Europolitics*, November 19, Section 4086.

[19] Collins, Sarah (2010) "Financial Services Two Years On: Progress on Financial Reform" November 19, *Europolitics*, Section 4086.

[20] Brush, Silla and Phil Mattingly (2011) "OCC's Walsh Says Dodd-Frank Credit-Rating Ban May Block Basel III Adoption", *Bloomberg*, Feb 17, at http://www.bloomberg.com/news/print/2011-02-17/occ-s-walsh-says-credit-rating-ban-may-block-basel-iii-adoption.html, accessed May 6, 2011.

Is Basel III captured?

Critics have argued that Basel II served the interests of the large transnational banks, not the public interest.[21] The process in which the main global lobby group for those banks, the Institute of International Finance, had privileged access to the BCBS, the IIF's pride in having persuaded the BCBS to allow banks to rely on their own risk management systems in calculating their capital adequacy levels, the lower capital costs that the large banks subsequently enjoyed relative to their competitors who did not have the capacity to develop those internal risk models, and the general weakness of bank regulation all lend support to this view. Some contrary arguments should be noted however. The BCBS could not reasonably impose a complex set of standards without consulting with the industry, and the IIF was the most efficient way to do this. In principle there is no reason that a supervisor's demanding scrutiny and high standards for a bank's internal model could not result in a strong form of regulation where the risk management costs are imposed on the bank. However in the wake of the crisis there is little room for disagreement that standards at all levels were too weak, and that the power of the industry played a key role in this. For this paper's purposes a key question is whether Basel III continues this pattern or if it instead moves the regime towards the public interest and away from capture. In the theoretical section I identified two questions to consider in assessing the risk of capture and in this section I consider these.

The first question was whether business is prominent in the four processes that indicate the likely power and autonomy of transnational standards relative to actors other than business? There is little change in the *market* environment that public officials are seeking to regulate. Although some banks were nationalized during the crisis there is no serious discussion of having governments play a more direct role in the operations of financial markets over the longer run. In the *policy* environment there is certainly a heightened awareness of the risk of financial crisis in the developed country governments and legislatures that had not previously experienced such crises in their own jurisdictions. Even though this is fading over time, the legislation and new bodies that have been set up on response to the crisis will lock in to some degree a heightened degree of public scrutiny. Similarly the strengthening of the public sector institutions at the transnational level when the private sector ones such as the IIF have remained more constant in their power will tip the balance away from capture. Some private sector actors have a strong interest in the reforms that are being considered. This includes, for instance, the CCPs, and the contingent capital bonds market, which could play a significantly bigger role in the new capital adequacy regime.[22] The FSB has announced that it will establish a series of regional consultative groups as a way to connect with non-member financial authorities, and it has been asked by the G20 to partner with the IMF and World Bank on a task force involving non-member financial authorities to consider issues relevant to emerging and developing economies. These are additional useful mechanisms for broadening accountability. However the involvement of non-business NGOs remains insignificant.

The second question was whether there is evidence that transnational standards are difficult for the industry (indicating a lack of capture), and if so is the industry successful in reversing them (with a reversal indicating capture)? Private sector resistance to elements of Basel III has been fierce at times. The extension of the deadline for the completion of key elements of

[21] See references in note 2 above.

[22] Patnaude, Art (2011) "Coco Bonds Could Shift Investor Base for Bank Debt," *Dow Jones Capital Markets Report* March 24, accessed through LexisNexis.

Basel III to as late as 2019 was a response to bank arguments that a faster pace would harm them and restrict their ability to lend. Following some of the more alarming warnings issued by the banking industry the FSB and the BCBS produced studies concluding that "the transition to stronger capital and liquidity standards is likely to have a modest impact on aggregate output."[23] Nevertheless the deadlines were extended. Some observers have argued that Basel III is too weak. For instance Lord Adair Turner, chair of the UK's Financial Services Authority, argued in early 2011 that Basel III should have set the core capital at a ratio of 15% to 20% rather than the 7% that was agreed.[24] Stefan Walter, Secretary General of the BCBS also warned in April 2011 that "Despite the severity of the crisis, we are already seeing signs that its lessons are beginning to fade" and that the risk of banking crises in one of the BCBS members was roughly one in 20, "unacceptably high."[25] At the same time it seems clear that Basel III does impose serious costs on banks and is significantly restricting their riskiness. A 2010 BCBS report estimated that the 94 largest banks would have to raise €577 billion. The big banks also were below the liquidity standards, with only 83 percent of the short-term cash needed.[26] A respected Wall Street analyst, Charles (Brad) Hintz published a detailed report on Dodd-Frank and Basel III, in November 2010 concluded that the changes will make banking significantly less profitable, clients will be charged more to borrow, and compensation ratios will come down.[27] Had Basel III been fully implemented in 2010 banks would have been forced to raise €2.9 trillion in one year to meet the liquidity standards.[28] Thus at least part of the delay in implementation could reasonably be attributed to the need not to disrupt the global financial system too severely.

Recent industry responses to Basel III have been quite varied. For instance the Global Financial Markets Association, the key representative of capital market actors, in its February 2011 remarks to the BCBS on Basel III noted that "we acknowledge that the new standards will help protect financial stability and promote market confidence." Its major emphasis was on requests for clarity and consistency rather than demands to roll back or abandon Basel III.[29] Similarly the IIF has not issued reports criticizing Basel III since its adoption, and generally has focused on clarifying its provisions and seeking to influence rules that are not yet finalized. The IIF Managing Director, Charles H. Dallara, has indicated that banks can live with Basel III as long as there is enough time for them to adjust, but that he is concerned that some countries are raising the bar above the Basel standards.[30] However Rick Waugh, CEO of Scotia Bank, Vice-Chair of the IIF, and Co-Chair of the IIF's Special Committee on Implementation argued in April

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[23] Bank for International Settlements (2010) "Assessment of the macroeconomic impact of stronger capital and liquidity requirements", Press release, August 18, at http://www.bis.org/press/p100818.htm, accessed May 8, 2011.

[24] Kumar, Nikhil (2011) "Banking Rules are not Strong Enough, Warns FSA's Chairman," *The Independent*, http://www.independent.co.uk/news/business/news/banking-rules-are-not-strong-enough-warns-fsas-chairman-2244033.html, Accessed May 8, 2011.

[25] Wilson, Harry (2011), "Banking Crisis Risk 'Unacceptably High'", *Daily Telegraph* April 7, Business p. 4.

[26] Ewing, Jack (2010) "Large banks falling short of capital requirements," *International Herald Tribune*, December 17, p. 14.

[27] Rose-Smith, Imogen (2010) "The End of Proprietary Trading May Hit Banks' Profits But Help Their Stock Prices," *Institutional Investor* January 11, Accessed through LexisNexis. See also Demos, Telis (2010) "New Regulations Set to Hit Banks' Profits," *Financial Times* November 12.

[28] Brunsden, Jim (2010) "New bank rules would have set off '09 shortfall; US$3.82-trillion if rules in place at end of last year," *Financial Post* (Canada), December 17, p. FP10.

[29] GFMA (2011) "Basel 3 Framework: Outstanding Issues on Basel III Standards and Processes," Letter to Nout Wellink, Chair of the BCBS, February 4.

[30] Ewing, Jack (2010) "Backing Expected for Bank Rules: G-20 Nations Dismiss Fears of Damage from Capital Requirements," *International Herald Tribune*, November 11, p. 4.

2011 that “the approach currently being taken is in danger of placing too much emphasis on overly prescriptive rules and requirements, which have never proven effective in preventing crises.”[31] The Association of German Banks argued in April 2011 against the G-SIFI project, claiming that separate rules for G-SIFIs or higher capital charges are not the right approach.[32] The *Wall Street Journal* reported that at the 2011 World Economic Forum banks “bankers and their lobbyists say they will be jetting into the Alps armed with long lists of proposed and pending rules that they would like to water down or kill altogether.” However it also reported that the focus is on rules that are not yet finalized, particularly those targeted at G-SIFIs, and it concluded that the argument against the G-SIFI rules “isn't likely to sway many policy makers. Bailouts of giant banks, not small ones, have been costly and deeply unpopular for many Western countries.”[33] Consensus on G-SIFIs may not be achieved. In November 2010 Nout Wellink, who has headed the BCBS, noted that countries may be allowed to exempt their banks from the G-SIFI provisions once they are agreed,[34] which would seriously weaken them.

There have been at least two remarkable US examples of the industry’s ability to subvert the intent of the reform. A *New York Times* investigation suggested that the largest banks had used the shift of derivatives trading to clearinghouses to increase their exclusion of competitors by dominating the clearinghouse.[35] Concerns about this type of anti-competitive behavior inspired EU anti-trust regulators to initiate investigations into anti-competitive practices in derivatives markets.[36] Similarly, the Dodd-Frank Act sought to increase the accountability of credit rating agencies by exposing them to legal liability, but the Securities and Exchange Commission defeated this intent by exempting the CRAs through a “no action” letter after the agencies indicated that they would stop rating mortgage-backed securities.[37]

In sum, it is hard to predict with certainty the degree to which industry will be able to subvert Basel III and related regulatory initiatives as they are implemented. However it seems reasonable to see the aspects of Basel III that were endorsed by the G20 in November 2010 as relatively settled, with the industry itself moving on to other issues, such as G-SIFIs or national regulations that exceed Basel III. It also seems clear that Basel III sets a path midway between the banks’ preferences and the degree of regulation that would be necessary to ensure that crises do not reoccur. In other words, it shifts agreed regulatory standards significantly upward, but not as far upward as may be optimal from the perspective of systemic stability. In part this seems due to the ability of banks to lobby for their own private interests, and in part due to concern about the impact on the global economy of imposing regulatory demands on banks too quickly or severely. At the same time it is clear that banks continue to argue that regulation is too heavy, and they may enjoy more success in pressing their case as the memory of the crisis continues to fade.

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[31] Greenwood, John (2011) “Regulations could hamper growth: Scotia; One-size-fits-all approach flawed, CEO says,” *Financial Post* (Canada), April 6, p. FP4.
[32] “Separate Rules for G-SIFIs not the Answer: German Banks,” *Euroweek* April 1, 2011. Accessed through LexisNexis.
[33] Enrich, David (2011) “Banks Return with a Goal: Pushing Back,” *Wall Street Journal*, January 26, Accessed through Proquest.
[34] Ewing, Jack (2010) “Regulator for Banks Hints at Leeway: G-20 Panel Wanted Rules to Prevent Problems from Crossing Borders,” *International Herald Tribune* November 12, p. 7.
[35] Story, Louise (2010) “A Secretive Banking Elite Rules Trading in Derivatives,” *New York Times* December 11.
[36] Story, Louise and James Kanter (2011) “Europe Investigating Banks over Derivatives,” *New York Times* DealB%k, April 29.
[37] Morgenson, Gretchen (2011) “Hey, SEC, That Escape Hatch is Still Open,” *New York Times* March 5.

Conclusion

This paper has sought to answer the question of whether Basel III will help prevent future financial crises by asking two further question: how powerful and autonomous are the standards, and are they captured by the industry or do they represent the public interest in financial stability? Theoretically I discussed four factors that can contribute to the strength and autonomy of standards which are often underestimated by more state-centric approaches. I also specified two questions to help assess the degree to which the transnational regulatory process was captured.

My examination of Basel III suggested that it is a complex integrated set of standards that are embedded in the operations of the global financial system to a significant degree, that are being pursued in a functional mode rather than being a series of nationally-oriented bargains, and that display a high degree of path dependency and incremental forward movement, even in 2011, as the crisis has begun to fade. This suggests, contrary to Helleiner and Palgiari's prediction, that the standards are strengthening and becoming more uniform rather than becoming more decentralized and fragmented. My examination of Basel III also indicated that it was seriously constraining banks, and at the moment they are not likely to reverse the parts of Basel III that have already been endorsed by the G20, although the fate of the rest of the ongoing work is less clear. This work is pushing forward, but lobbying is fierce and may succeed at weakening it.

The overall conclusion, then, is that Basel III is useful in raising global standards and thereby reducing the likelihood of another crisis. However it does not raise them enough to ensure that such crises do not occur again: indeed it is weak enough that such crises are likely, even if Basel III has reduced this risk relative to the risk if Basel III had not been developed and agreed. There is an ongoing risk that the standards will be undermined or that their further development will be halted. This is not dissimilar to global governance in other issue areas: vital, inadequate, but better than nothing.