ARE INTERNATIONAL CAPITAL ADEQUACY RULES ADEQUATE? THE BASLE ACCORD AND BEYOND

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INTRODUCTION

No institution has shaped the economic development of the world more than the bank.¹ In its most unadorned form, a bank is a “business establishment authorized to perform financial transactions, such as receiving or lending money.”² Every bank has assets equal to the sum of its liabilities and equity—capital.³ Bank capital, or bank equity, can thus be described as the bank’s residual interest in its assets. Every bank bears the risk that its assets are actually worth less than the stated value on its balance sheet. If asset market values decline, fewer asset dollars will be available to settle the constant liabilities of the bank, resulting in a corresponding decrease in capital. If a bank’s capital decreases too much, the bank may be unable to satisfy its obligations and therefore become insolvent. Consequently, governments have sought to reduce bank insolvency through capital adequacy regulation. For bankers, lawyers, and even professors, these combined regulations constitute an overwhelming brain-teaser of financial law.⁴ Nonetheless, bankers, economists, lawyers, and legal scholars must understand these regulations because the “capital adequacy regime is the single most important set of rules and proposals in both international and domestic banking law.”⁵ This Comment seeks to aid those trying to understand this “multibillion-dollar global regulatory scheme

¹ See PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 488 (15th ed. 1995) (stating that “from a macroeconomic vantage point the most important instrument is bank money . . . primarily provided today by commercial banks”).

² THE AMERICAN HERITAGE DICTIONARY 67 (3d ed. 1994).

³ See ROBERT F. MEIGS & WALTER B. MEIGS, *ACCOUNTING: THE BASIS FOR BUSINESS DECISIONS* 20 (9th ed. 1993) (defining the central “accounting equation” as “Assets = Liabilities + Owner’s Equity”).

⁴ See Raj Bhala, *Equilibrium Theory, the FICAS Model, and International Banking Law*, 38 HARV. INT’L L.J. 1, 4 (1997) (“Even the international banking law scholar, who has time for quiet reflection, admits it is ‘impossible to keep up.’”).

⁵ *Id.* at 21.

promulgated by banking regulators"⁶ by examining the architectural role played by the Basle Committee on Banking Supervision, outlining global capital adequacy standards that are currently enforced, and evaluating proposals to change the present regulatory regime.

Part I addresses the nature of banking, the importance of capital within the banking system; and the broader question whether capital regulation is necessary. Part II examines the role, structure, authority, and international influence of the Basle Committee on Banking Supervision. The current Basle Accord of 1988,⁷ which has been adopted by the G-10 nations⁸ and most other industrialized countries,⁹ is the subject of Part III, which also details the current regulations and the policy considerations that led to them. In particular, Part III focuses on why the current regulatory regime has not achieved the various policy goals for which it was designed. Part IV then explains the 1999 proposal by the Basle Committee¹⁰ to amend the 1988 Accord by allowing, inter alia, a system of private rating agencies and internal rating methods to replace the current predetermined asset ratings. This Comment examines the policy rationales behind this new proposal and highlights the strengths and weaknesses of implementing such a regulatory structure. Part V introduces a second alternative to the current regulatory regime, proposed by the U.S. Shadow Financial Regulatory Committee, which would require banks to carry a specific amount of uninsured, subordinated debt.¹¹ The Conclusion reiterates the seven major flaws of the 1988 Basle Accord, and argues that the

⁶ David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT'L L.J. 281, 282 (1998).

⁷ See Bank for Int'l Settlements: Basle Comm. on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988) <<http://www.bis.org/publ/index.htm>> [hereinafter *Basle Accord*] (setting out the guidelines known as the 1988 Basle Capital Accord).

⁸ The G-10 consists of the "ten industrial nations that agreed in 1962 to lend money to the International Monetary Fund (IMF). They are Belgium, Canada, France, Italy, Japan, Netherlands, Sweden, Germany," the United Kingdom, and the United States. HAL S. SCOTT & PHILIP A. WELLONS, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION* 1239 (6th ed. 1999).

⁹ See *infra* Part III.D (discussing the countries that have adopted the Basle Accord).

¹⁰ See Basle Comm. on Banking Supervision, *A New Capital Adequacy Framework* (June 1999) <<http://www.bis.org/publ/index.htm>> [hereinafter *New Framework*] (outlining a major revision to the 1988 Accord).

¹¹ See U.S. Shadow Fin. Regulatory Comm., *International Bank Capital Regulation: A Flawed System in Need of Reform* 29 (Sept. 15, 1999) (unpublished manuscript, on file with the *University of Pennsylvania Law Review*) [hereinafter *Shadow Proposal*]; see also U.S. Shadow Fin. Regulatory Comm., *Statement No. 160: Reforming Bank Capital Regulation* (Mar. 2, 2000) <<http://www.aei.org/shdw/shdw160.htm>> [hereinafter *Statement No. 160*] (discussing international bank standards).

Basle Committee's 1999 Proposal to replace the original Accord with the *New Capital Adequacy Framework* ("New Framework") does little to ameliorate the "seven sins" of the current regime and will even engender additional dilemmas upon its implementation. Operating on the assumption that bank capital regulation is necessary, this Comment suggests that regulators should consider centering such regulation on a subordinated debt requirement that enhances market discipline. Finally, it argues that the prefatory assumption of the necessity of bank capital regulation is itself a seemingly flawed premise that should be scrutinized vigilantly.

I. BANKS, CAPITAL, AND REGULATION

A. *The Importance of Banking to the Economy*

All market economies rely on the voluntary relationships of autonomous individuals acting in their self-interest to create wealth through productive enterprise.¹² For most enterprises, economic inputs fundamental to the entity's success are not initially owned by the enterprise. Entities and individuals contract with one another to form borrower/saver relationships. Savers provide economic inputs to borrowers who use such inputs to generate economic outputs. Borrowers, in turn, promise a return of their inputs, as well as a portion of the net output (i.e., principal plus interest), to savers. By serving as "intermedia[ries] between savers and borrowers," banks have eliminated much of the inherent inefficiency and risk in this process.¹³ Banks thus "raise funds by issuing their obligations to savers, and provide these funds to borrowers by acquiring the borrower's obligations."¹⁴ In effect, banks have earned their profits through the interest rate spread between the rate they pay on deposits and the rate they charge for loans.

The advent of banks resulted in an "efficient payment system"¹⁵

¹² See generally ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776) (discussing how societal wealth is generated through the self-interested pursuits of individuals).

¹³ TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 18 (1998).

¹⁴ *Id.*; see also Walter I. Conroy, Note, *Risk-Based Capital Adequacy Guidelines: A Sound Regulatory Policy or a Symptom of Regulatory Inadequacy?*, 63 FORDHAM L. REV. 2395, 2412-13 (1995) ("[Banks] solicit funds in the form of demand deposits and time deposits from individuals with a surplus of savings and pass these funds on in the form of loans and investments to companies and individuals who have a deficit of funds.").

¹⁵ Conroy, *supra* note 14, at 2412.

that financed the Industrial Age.¹⁶ Today, banks are much larger and more complex than they were a few hundred years ago, yet their main function as intermediaries between savers and borrowers remains, and they continue to flourish. The most significant trend in banking is "globalization."¹⁷ For the past decade, American banks have been establishing branches, subsidiaries, agencies, and representative offices in foreign countries at astonishing rates, and other nations' banks are doing the same in the United States.¹⁸ Bank customers are no longer only individuals and entities from the bank's home country. For example, an American bank (intermediary) may loan a British corporation (borrower) money that was initially deposited by a Japanese bank (saver). International banking centers have emerged, creating more competition among banks and expanding the parameters of commercial payment systems.¹⁹ The current legal systems of individual nations, however, are more or less insufficient to address the tumultuous changes arising from globalization.²⁰

B. *The Importance of Capital in Banking*

The bank's role as a financial intermediary involves many specific risks, of which the most predominant is credit risk—that a borrower will default on a loan.²¹ On a bank's balance sheet, a loan is classified

¹⁶ See NATHAN ROSENBERG & L.E. BIRDZELL, JR., *HOW THE WEST GREW RICH: THE ECONOMIC TRANSFORMATION OF THE INDUSTRIAL WORLD* 166 (1986) (stating that in the Industrial Revolution, "[t]he funding of the factories was facilitated by the English system of country banks which, by the usual effects of deposit banking, created the money supply needed for their factory customers' working capital").

¹⁷ Shadow Proposal, *supra* note 11, at 1; see also SCOTT & WELLONS, *supra* note 8, at 216 (describing the "dramatic growth in banks' international and cross-border activities").

¹⁸ See SCOTT & WELLONS, *supra* note 8, at 89-90 (describing the "importance of foreign banks" to our national economy).

¹⁹ See IAN F.G. BAXTER, *INTERNATIONAL BANKING AND FINANCE* 55-62 (1989) (discussing the impact of the three major international financial centers, London, New York, and Tokyo, on banking).

²⁰ See generally RAJ K. BHALA, *FOREIGN BANK REGULATION AFTER BCCI* 1-23 (1994) (discussing the virtual ineptness of individual countries' legal systems to regulate the activities of global banks, especially with regard to the Bank of Credit and Commerce International ("BCCI"), the world's seventh largest private bank with operations in over 72 countries, which had engaged in many illegal activities in the 1980s and early 1990s that led to its insolvency).

²¹ "Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms." Basle Comm. on Banking Supervision, *Principles for the Management of Credit Risk* (July 1999) <<http://www.bis.org/publ/index.htm>>; see also Thomas W. Albrecht & Sarah J. Smith, *Corporate Loan Securitization: Selected Legal and Regulatory Issues*, 8 DUKE J. COMP. & INT'L

as an asset, because it is an entitlement of the bank to receive a certain amount of money (plus periodic interest payments) on a given date from a borrower. The main liabilities on a bank's balance sheet are its deposits, or obligations to reimburse savers on a specified date or upon demand. The amount of net assets (assets minus liabilities) is thus the bank's capital.²² Capital is generally "a financial cushion that absorbs banks' losses and thus protects depositors—or any entity that insures depositors—from loss."²³

L. 411, 414 (1998) ("By far the greatest type of risk incurred in carrying on a banking business is the credit risk inherent in the holding of long-dated assets, particularly since the principal funding source of most banks traditionally has been short-dated deposits."); *Basle Papers Set Tone for Sweeping Accord Overhaul*, FIN. NEWS, Aug. 2, 1999, available in 1999 WL 5992124 ("Regulators maintain that credit risk, or the risk of loss which banks face if a borrower or counterparty to a deal defaults, accounts for anything up to 90% of a bank's overall risk profile. It still represents the greatest threat to the health of the global banking system."); *BIS Reviews Basle Committee Guidelines*, EUR. BANKER, Feb. 24, 1994, at 4 ("Credit risk—that a borrower cannot repay a loan—is still the main risk facing banks.").

The definition of credit risk can be made even more expansive. *See id.* ("Credit risk today, however, now includes such things as exposure to counterparty risk from margin lending, over-the-counter derivatives, foreign exchange settlement or credit derivatives."). Loan defaults, however, are still the primary component of credit risk.

Besides credit risk, banks are also susceptible to market risk, interest rate risk, liquidity risk, and others. Market risk is the "risk of losses in on and off-balance-sheet positions arising from movements in market prices, including interest rates, exchange rates and equity values." The Wharton Sch. of Bus., International Banking Glossary 20 (July 21, 1994) (unpublished manuscript, on file with the *University of Pennsylvania Law Review*). Interest Rate Risk is the "risk that changes in the market interest rates might adversely affect an institution's financial condition." *Id.* at 17. Liquidity Risk is the "risk that the firm will be unable to fund assets or meet obligations at reasonable cost or at all; for financial assets, the risk that an instrument cannot be sold or otherwise exchanged for its full market value." *Id.* at 19.

²² This refers to "capital" in the academic sense of the term. By contrast, "Regulatory Capital" often encompasses long-term liabilities. *See infra* text accompanying notes 97-104 (noting that regulatory capital can include such diverse instruments as non-equity capital, bonds that do not mature for some time, as well as common equity). Regulators often treat debt with a distant maturity date (e.g., 20-30 years) as "quasi-capital" since there is no obligation to pay savers in the current period.

²³ Shadow Proposal, *supra* note 11, at 1; *see also* FRIEDRICH A. HAYEK, *THE PURE THEORY OF CAPITAL* 54 (1941) (defining capital as "the aggregate of those non-permanent resources which can be used only in this indirect manner to contribute to the permanent maintenance of the income at a particular level"); CHRIS MATTEN, *MANAGING BANK CAPITAL: CAPITAL ALLOCATION AND PERFORMANCE MEASUREMENT* 7 (1996) ("An essential element of capital is therefore its availability to absorb future, unidentified losses.").

Consider the following hypothetical balance sheet:

Assets (Loans) \$100,000,000	Liabilities (Deposits) \$90,000,000
	Equity (Capital) \$10,000,000
Total: <u>\$100,000,000</u>	Total: <u>\$100,000,000</u>

In this case, the bank has \$100,000,000 in loans that it is entitled to receive from its borrowers. It concurrently has an obligation to pay its savers \$90,000,000 upon withdrawal of their deposits. The \$10,000,000 in capital serves as a 10% default cushion against the outstanding loans. What would happen if a downturn in the economy or reckless management caused the borrowers to default on 15% of the loans? The realized credit risk would then be 15% of total assets. Consider the revised balance sheet:

Assets (Loans) \$85,000,000	Liabilities (Deposits) \$90,000,000
	Equity (Capital) (\$5,000,000)
Total: <u>\$85,000,000</u>	Total: <u>\$85,000,000</u>

The bank now has the possibility of recovering only \$85,000,000, but its obligations remain \$90,000,000. The net worth of the bank is negative \$5,000,000. The test for bank insolvency is simple: "[b]anks fail when their losses exceed their capital."²⁴ Applying this test, the negative \$5,000,000 net worth is again evident since losses were \$15,000,000 and bank capital was only \$10,000,000. In this simplified hypothetical, the bank only had a 10% capital cushion, a capital ratio that was *inadequate*. Capital adequacy²⁵ laws are created to prevent this very situation.

While the technical function of capital is to ensure that net liabilities do not exceed net assets, capital also functions in more dynamic ways:

[B]ank capital serves four primary functions. First, it inspires public confidence in the bank's viability by absorbing unanticipated losses. Second, it protects uninsured depositors in the event of bank insolvency.

²⁴ Shadow Proposal, *supra* note 11, at 6.

²⁵ See John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J.L. & PUB. POL'Y 70, 81-82 ("Capital adequacy refers to the ability of a bank to face risks by relying on amounts that have been paid in by the shareholders, together with certain other reserves.").

Third, it pays for the acquisition of physical plants and other resources necessary to operate the bank. Finally, it serves as a regulatory restraint on unjustified asset growth.²⁶

Since adequate capital is a necessary condition for solvent banks, and solvent banks are fundamental to the world economy, adequate bank capital is thus essential for a sound economy. Many assert that "[a] sufficient level of capital backing can cushion the most serious shocks to the banking system as well as forestalling systemic failure."²⁷ Because adequate bank capital is a vital component of economic stability, it has become a subject of concern for financial regulatory bodies around the world.

C. *Capital Adequacy: Why Government Regulation?*

Capital adequacy is not a phenomenon exclusive to banks. Every business, from a corner snowcone stand to a Fortune 500 company, possesses the inherent risk of incurring losses that exceed capital. Government, however, does not interfere with the balance sheets of operating companies by mandating specific ratios of capital to assets. Firms are expected to maintain adequate capital the old-fashioned way—through self-imposed, prudent management. Businesses that misjudge risks and the capital needed to serve as a buffer against them either become entirely insolvent or suffer punishment by acquiring reputations for not paying their debts. Individuals or businesses may refuse to enter into contractual obligations with a company known to be lacking in capital, or charge additional rents for the transaction to compensate for the increased risk. Because of this dynamic function of free enterprise, imprudent firms are disciplined not by the government, but by the market.²⁸ This reasoning is perhaps the most persuasive argument against the necessity of capital adequacy standards.

²⁶ Duncan E. Alford, *Basle Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry*, 10 DICK. J. INT'L L. 189, 191 (1992) (citing G. HEMPEL ET AL., *BANK MANAGEMENT: TEXT & CASES* 272 (3d ed. 1990)).

²⁷ *The Great Banking Capital Conundrum*, RETAIL BANKER INT'L, Apr. 30, 1999, at 17, available in 1999 WL 13033209 [hereinafter *Capital Conundrum*].

²⁸

[L]osses indicate that the firm has taken important resources and diminished their value. Losses also help separate people with poor judgment from the control of resources. One of the market's greatest strengths is its ability to match greater control over society's resources with those who have the best ability to make decisions.

WAYNE GABLE & JERRY ELLIG, *INTRODUCTION TO MARKET-BASED MANAGEMENT* 26 (1993).

Many economists and legal scholars believe that the market alone, and not the government, should regulate bank capital. Before the government ever considered comprehensive capital regulations or mass deposit insurance, the market was solely responsible for the task:

Before governments protected banks' depositors from loss, banks were subject to market discipline much like other corporations. Except for minimum capital requirements at the time a bank was chartered, the amount of its capital was determined by the market. If depositors believed that a bank had insufficient capital to protect the par value of their deposits, they could withdraw their funds. That threat encouraged banks to maintain sufficient capital, commensurate with their portfolio risk, to ensure the continued confidence of their depositors, thereby avoiding a run on the bank that might put it out of business.²⁹

Austrian economist Ludwig von Mises affirmed that "conservatism and [a] reluctance to expand credit... [are marks of restraint, which] is the first and supreme rule for the conduct of banking operations under free banking."³⁰ If the government attempts to set capital adequacy standards, only three outcomes are possible. First, the government standards could match those of the market. Given the unpredictability of markets, this outcome is highly unrealistic. Second, the government capital standards could be lower than the market requires. If this is the case, the bank will either ignore the government requirements and maintain a larger capital cushion, or it will obey the regulations at its peril. This situation may cause a moral hazard since banks could justify imprudent management by arguing that they met the minimal standards required by law.³¹ The third possible outcome is that the regulations could require more than the optimal amount of capital needed for efficient banking operations. Having a larger capital cushion than necessary would certainly prevent insolvency (at least in the short-run), but it would result in higher interest rates on loans

²⁹ Shadow Proposal, *supra* note 11, at 6.

³⁰ LUDWIG VON MISES, *HUMAN ACTION: A TREATISE ON ECONOMICS* 447 (3d ed. 1966). "If the governments had never interfered, the use of banknotes and of deposit currency would be limited to those strata of the population who know very well how to distinguish between solvent and insolvent banks." *Id.* at 448; see also DAVID REISMAN, *THE POLITICAL ECONOMY OF JAMES BUCHANAN* 93-94 (1990) (discussing why the interference of central banks in regulating other banks causes more harm than good).

³¹ This moral hazard is especially prevalent in bank capital regulation. "Banking is a highly leveraged activity. The size of the capital base is a key parameter in determining potential profitability." *Capital Conundrum*, *supra* note 27. If a bank can justify lowering its capital, it can make more loans and, at the same time, increase the amount of deposits for which it is liable.

and most likely reduce bank profits.³² Rigid capital adequacy standards may actually cause banks to fail by overburdening them with regulations to which their foreign or non-bank competitors are not subject.³³

The question is essentially whether banks should be permitted to operate as regular corporations with respect to freely managing their own levels of capital.³⁴ Despite cogent arguments against government regulation of bank capital, regulators have answered "no" and instituted a regime of capital adequacy rules. The crucial but delicate role of banks as the central financial intermediaries is the principal reason that bank capital is regulated while the capital of other companies is not.³⁵ There are at least four specific reasons provided by regulators mandating minimal bank capital. First, a capital cushion can guard against "runs" by depositors who fear that a bank will be unable to repay its debts.³⁶ Second, by requiring a certain ratio of capital to assets, governments posit that the risk of systemic bank failures will be reduced. Since banks are linked together through payment systems, the collapse of one bank could trigger a domino effect of bank failures.³⁷

³² See MATTEN, *supra* note 23, at 7 ("[T]he level of capital affects the return required by shareholders and a bank with a lower capital requirement would be able to price its products more keenly, as its threshold return would be lower.").

³³ See *The Regulation of International Banking*, in 11 FINANCIAL CENTRES 5 (1989) [hereinafter 11 FINANCIAL CENTRES] ("[I]f the requirements shield banks and their customers from the dangers of an over-aggressive management they cannot shield them from the possibility of stagnation or the perils of cut-throat competition."); Conroy, *supra* note 14, at 2442 ("When regulators interfere with the market by creating adequacy guidelines, they do not necessarily ensure the stability of individual banks.").

³⁴ See John J. Mingo, *Toward an "Internal Models" Capital Standard for Large Multinational Banking Companies*, 80 J. LENDING & CREDIT RISK MGMT. 49, 53 (1998) (phrasing the question as, "should major banks operate with such a high default probability (i.e., should they operate as if they were well below investment-grade corporations)?").

³⁵ There has been some regulation by the SEC and the securities regulation agencies of other nations mandating capital standards for financial services companies such as investment banks and brokerage houses. See SCOTT & WELLONS, *supra* note 8, at 251 (discussing such regulatory efforts). "The International Organization of Securities Commissions (IOSCO) tried to issue common standards for its members but the effort collapsed in late 1992." *Id.* at 252. In Europe, entities providing financial services other than banking are also required to maintain a certain amount of capital as a cushion against losses. "For members of the European Union, the European Commission issued the Capital Adequacy Directive (CAD) for investment firms and credit institutions in March 1993." *Id.* at 251.

³⁶ See Shadow Proposal, *supra* note 11, at 6-7 (discussing the potential adverse effects of runs).

³⁷ See Lawrence L.C. Lee, *The Basle Accords As Soft Law: Strengthening International Banking Supervision*, 39 VA. J. INT'L L. 1, 2 (1998) ("[O]ne attendant risk arising from the growth of financial globalization is the potential for international financial crises

Third, a safe capital cushion will prevent a taxpayer bailout of the banking system in nations that have a deposit insurance regime.³⁸ Fourth, capital adequacy standards, especially if they are international in scope, will prevent the "race to the bottom" situation stemming from competition to over-leverage assets.³⁹

For the present, pro-regulation arguments have won the day; consequently, many nations favor the institution of capital adequacy standards for their banks. Many regulators firmly believe that "[c]apital standards help to ensure the financial strength of internationally active banks while promoting greater competition."⁴⁰ Therefore, it is important to explore not only the substance of those standards but also the process from which they arose.

II. THE BASLE COMMITTEE ON BANKING SUPERVISION

Current capital adequacy law is the product of a unique form of legal process. Because bank capital is a subject for national regulation, capital adequacy law is enacted by central governments. No international treaties bind the banks of different nations to maintain a certain level of capital. The United Nations has not instituted any restrictions on commercial banks' balance sheets. Nonetheless, capital adequacy laws are virtually identical throughout the world.⁴¹ The Basle Committee on Banking Supervision ("Basle Committee") gave birth to this peerless breed of internationalized national law.

which disrupt macroeconomic performance."). *But see* Michael Taylor, *The Search for a New Regulatory Paradigm*, 49 *MERCER L. REV.* 793, 804 (1998) ("The loss of confidence argument has probably been overstated in a modern economy: there is little evidence that the failure of one bank leads to a widespread systemic crisis as the result of panic withdrawals by depositors.").

³⁸ See Shadow Report, *supra* note 11, at 8 (noting that "deposit insurance also increases the banking system's tolerance for incompetent bankers who unwittingly increase risk" and who "lower their capital consciously to take advantage of the weaker depositor discipline produced by government insurance").

³⁹ See *Capital Conundrum*, *supra* note 27 (discussing the incentives for banks to fully leverage their assets absent market discipline guiding them to be more prudent).

⁴⁰ Susan M. Phillips & Alan N. Rechtschaffen, *International Banking Activities: The Role of the Federal Reserve Bank in Domestic Capital Markets*, 21 *FORDHAM INT'L L.J.* 1754, 1757 (1998).

⁴¹ See *infra* Part III (discussing the implementation of the 1988 Accord around the world).

A. *The Perceived Need for an International Standard*

Prior to the 1988 Basle Accord,⁴² the U.S. Congress had the responsibility of devising and promulgating the nation's capital adequacy regulations. Because drafting capital adequacy rules required a deep understanding of banking and economics, Congress shifted rule-making responsibility to the Board of Governors of the U.S. Federal Reserve by passing the International Lending Supervision Act of 1983 ("ILSA").⁴³ The new Act allowed the Federal Reserve to discuss capital adequacy standards with other central banks and encourage the adoption of uniform rules.⁴⁴ Through the new Act, "Congress essentially delegated authority to the Federal Reserve to negotiate international capital adequacy guidelines for commercial banks," illustrating Congress's "hands-off approach to international banking law."⁴⁵ Even though the Federal Reserve was authorized to prevent widespread inadequate bank capital, it found that promulgating standards for American banks alone would have little effect on what was a global dilemma.⁴⁶

Since the 1970s, there has been a "dramatic growth in banks' international and cross-border activities."⁴⁷ Many commentators have remarked that "[c]ross-border activity and the internationalisation of markets are the main financial evolutions of the end of this century."⁴⁸ When Federal Reserve regulators attempted to impose capital standards on U.S. banks, it became evident that such standards would fall short of the original goals of capital regulation. First, many American individuals and businesses were depositing money in foreign banks not subject to capital regulations. The Federal Reserve could do very

⁴² *Basle Accord*, *supra* note 7.

⁴³ Pub. L. No. 98-181, tit. IX, § 908, 97 Stat. 1278, 1280 (1983) (codified at 12 U.S.C. §§ 3901-3912 (1994 & Supp. II 1996)).

⁴⁴ *See id.* (discussing the powers of the Federal Reserve).

⁴⁵ Bhala, *supra* note 4, at 23-24.

⁴⁶ *See* MICHAEL GRUSON & RALPH REISNER, 1 REGULATION OF FOREIGN BANKS: UNITED STATES AND INTERNATIONAL 4-4 (1995) (explaining that when the first "risk-based capital proposal [by the Federal Reserve pursuant to ILSA] was issued for public comment in early 1986," the consensus "emphasized the importance of achieving uniformity of capital standards with other countries").

⁴⁷ SCOTT & WELLONS, *supra* note 8, at 216; *see also* Lee, *supra* note 37, at 10 ("Modern banks conduct diversified operations across borders to diversify their earning sources and enhance their profits. Advances in data processing and telecommunications have enabled banks to offer global services easily, even without establishing a physical presence in some markets.").

⁴⁸ Pierre Fleuriot, *Financial Regulation As the Safeguard of Balances in a Global Context*, in FINANCIAL MARKETS REGULATION 33, 33 (Alain Jeunemaitre ed., 1997).

little to prevent "runs" on these banks. Second, and more importantly, the danger of systemic risk was global and no longer within the confines of any national border.⁴⁹ Thus, even if capital standards were imposed on American banks, the insolvency of a major Japanese or European bank could cause U.S. banks to fail as well.⁵⁰ Third, since deposit insurance regimes were not instituted multilaterally, U.S. taxpayers may have had to face the bailout of U.S. banks failing as a result of foreign bank failures in other nations. Finally, the imposition of purely American capital adequacy standards may have curbed U.S. banks from racing to the bottom, but unregulated foreign banks would have continued the race, effectively gaining market share by offering higher interest rates to depositors and lower interest charges to borrowers as a result of retaining less capital. Not only would U.S. banks competing abroad be injured by such standards, but foreign banks wishing to establish U.S. subsidiaries (subject to U.S. banking regulations) would be deterred from doing so.⁵¹

The Federal Reserve simply decided that "the traditional regulatory paradigm [had] become outmoded."⁵² A major disjunction between the regulations and the regulated occurred: "banking [was] international, while banking regulation [was] national" in scope.⁵³ If capital adequacy regulation was going to comprise an effective legal regime, then regulators believed that it needed to be international in scope. Other nations were recognizing that many Cold War problems ameliorated by national solutions were becoming increasingly difficult to solve in the new post-Cold War era of economic globalization.⁵⁴

⁴⁹ See Shadow Proposal, *supra* note 11, at 1-2 ("[B]ecause international banks were active in multiple countries and were linked together through common clearing and settlement systems . . . the failure of one or more of these institutions in one country could adversely affect the financial welfare of other institutions in other countries.").

⁵⁰ See 11 FINANCIAL CENTRES, *supra* note 33, at 5 ("[T]he banking system is international; the failure of a bank in Frankfurt could affect the banking system around the world."); see also F.R. RYDER, *LEGAL PROBLEMS OF INTERNATIONAL BANKING* 49-52 (1987) (discussing problems international bankers faced in the years preceding the Basle Accord).

⁵¹ See Thomas F. McInerney III, Note, *Towards the Next Phase in International Banking Regulation*, 7 DEPAUL BUS. L.J. 143, 170 (1994) ("Naturally, the tighter the regulatory structure, the less attractive a country becomes for foreign banks.").

⁵² Taylor, *supra* note 37, at 793.

⁵³ Lee, *supra* note 37, at 32.

⁵⁴ See Kanishka Jayasuriya, *Globalization, Law, and the Transformation of Sovereignty: The Emergence of Global Regulatory Governance*, 6 IND. J. GLOBAL LEGAL STUD. 425, 428 (1999) ("The extensive international effort to regulate environmental, health, weapons, and even human rights standards bears witness to this trend toward international regulation. But nowhere is this demand for regulation more apparent than in the in-

The field of banking was no exception. International law, although very expansive in nature, is burdensome to forge. Such a process requires, at a minimum, a meeting of sovereign nations whose representatives negotiate the construction of doctrines and pledge to be bound by them.⁵⁵ Indeed, developing "hard"⁵⁶ international law can take years or even decades.⁵⁷

Apart from the difficult process of establishing international law to regulate bank capital, the Federal Reserve faced another problem. Many nations were circumspect to enter into agreements to establish rigid capital standards, fearing that doing so would doom the competitiveness of their respective banks.⁵⁸ For example, if one country submits to binding regulation, but its neighbor or main competitor is free from capital regulation, the commercial banks of the unbound nation may be able to achieve a strategic advantage. Such a competitive advantage would certainly be evident if the two nations' regulatory systems were basically equal in all other respects. Even though U.S. banks could probably endure such regulation without losing significant market share, the ability of foreign banks to bear the disadvantage of uneven regulation is much more doubtful.

Nonetheless, if capital adequacy regulation was to take on a global scope, two nations needed to make the first move toward regulatory integration. Even in the absence of "hard" international law, "financial globalization and liberalization . . . created a need for banks and banking supervisors to adopt international standards rather than following a series of purely domestic regulations."⁵⁹ The United States and the United Kingdom made this first move toward integration when "the Federal Reserve and the Bank of England^[60] entered into

ternational financial sphere.").

⁵⁵ See DANIEL G. PARTAN, *THE INTERNATIONAL LAW PROCESS* 86 (1992) (defining "general international law" as "rules of law that bind all members of the international community even though such rules have not been established by state practice"); BURNS H. WESTON ET AL., *INTERNATIONAL LAW AND WORLD ORDER* 11 (2d ed. 1990) ("International law governs relations between independent States." (quoting *S.S. Lotus* (Fr. v. Turk.) 1927 P.C.I.J. (ser. A) No. 10, at 18 (Sept. 7))).

⁵⁶ See Lee, *supra* note 37, at 7 (discussing the distinction between "hard" international law, which "places obligations on members," and "soft" international law).

⁵⁷ See PARTAN, *supra* note 55, at 85 (noting that rules of international law are "rarely easily established" (quoting Daniel G. Partan, *The "Duty To Inform" in International Environmental Law*, 6 B.U. INT'L L.J. 43, 64 (1988))).

⁵⁸ See McInerney, *supra* note 51, at 170 ("The political difficulties involved in creating an agreement among various states on supervisory standards are heightened by intertwined issues of competitiveness.").

⁵⁹ Lee, *supra* note 37, at 2.

⁶⁰ The Bank of England is the central bank of the United Kingdom. It performs

an agreement to implement common risk-based capital standards for banks in their respective countries"⁶¹ in January 1987. In little more than a year from the date of the United States-United Kingdom agreement, the remaining Group of Ten ("G-10") nations followed suit by adopting the capital adequacy standards issued by the Basle Committee.

B. *The Basle Committee: The Club of Giants*

The Basle Committee on Banking Supervision is a "standing committee of the central bank governors of the Group of Ten ("G-10") countries" that convenes at the Bank for International Settlements ("BIS") in Basle, Switzerland.⁶² The Basle Committee's objective is to eradicate the worrisome disjunction between the international banking system and the plethora of national banking regulations that have failed to restrain it. To this end, the Committee, along with its permanent staff at the BIS, engages in the research and study of international banking and makes recommendations to the governors of the G-10 central banks on how to better supervise and regulate banking activities with cross-border repercussions.⁶³ Since its founding, the Committee has published numerous papers⁶⁴ and held conferences attended by "bank supervisors from over 100 countries."⁶⁵ During its first ten years, the Basle Committee simply coordinated matters of regulatory and supervisory procedure.⁶⁶ Since capital adequacy rules are substantive, they were beyond the initial scope of the

functions similar to those of the U.S. Federal Reserve.

⁶¹ Alford, *supra* note 26, at 195-96.

⁶² SCOTT & WELLONS, *supra* note 8, at 217. The BIS was originally established in 1930 as a financial entity to oversee the payment of reparations resulting from the First World War. See *id.* at 1233 (describing the BIS as "[a]n international bank originally established in 1930 as a financial institution to coordinate the payment of war reparations between European central banks"); *Bank for International Settlements—Information About the BIS* (last modified Jan. 2000) <<http://www.bis.org/about/index.htm>> (explaining the history of the BIS). Today, the BIS sponsors the Basle Committee in the limited capacity of secretariat. See *id.* (providing a profile and general information on the BIS). As secretariat, the BIS provides both a neutral forum for debate and support staff to maintain the Committee's communications with the world. The BIS initiated its sponsorship of the Committee in 1976, endeavoring to "coordinate banking supervision in member countries." SCOTT & WELLONS, *supra* note 8, at 217.

⁶³ See SCOTT & WELLONS, *supra* note 8, at 217 (discussing the relationship between the Committee and G-10 central bankers).

⁶⁴ See *Bank for International Settlements* (visited Mar. 4, 2000) <<http://www.bis.org/publ/index.htm>> (listing the Basle Committee's publications during the past decade).

⁶⁵ SCOTT & WELLONS, *supra* note 8, at 217.

⁶⁶ See *id.*

Committee's activities. This would soon change.

The members of the Basle Committee are all central bankers⁶⁷ whose governments depend on their expertise and consequently delegate immense regulatory authority to them.⁶⁸ This regulatory authority often includes the ability to establish capital adequacy standards for commercial banks. The transition of the Committee toward designing *substantive* rules for international capital adequacy was imminent. The Federal Reserve and its counterparts now had a mechanism whereby capital adequacy regulation could be standardized among the most sophisticated international financial systems. In 1988, the Committee issued a paper on the "International Convergence of Capital Measurement and Capital Standards,"⁶⁹ which essentially prescribed a substantive set of risk-based capital adequacy standards. These standards have been adopted by the respective nations through their central bankers represented on the Basle Committee.⁷⁰

The Basle Committee is relatively unknown, in comparison to its indisputable influence.⁷¹ This is partly by design.⁷² The Basle Com-

⁶⁷ Membership in the committee is limited. The institutions represented on the Basle Supervisors Committee are:

Belgium: National Bank of Belgium, Banking Commission

Canada: Bank of Canada, Office of the Inspector General of Banks

France: Bank of France, Banking Commission

Germany: Deutsche Bundesbank, Federal Banking Supervisory Office

Italy: Bank of Italy

Japan: Bank of Japan, Ministry of Finance

Luxembourg: Luxembourg Monetary Institute

Netherlands: The Netherlands Bank

Sweden: Sveriges Riksbank, Royal Swedish Banking Inspectorate

Switzerland: Swiss National Bank, Swiss Federal Banking Commission

United Kingdom: Bank of England

United States: Federal Reserve Board, Federal Reserve Bank of New York, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation

Secretariat: Bank for International Settlements

JOSEPH JUDE NORTON, *DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS* 176 n.18 (1995).

⁶⁸ The immense delegation of regulatory responsibility to central banks is especially true in the United States. "While the Federal Reserve is subject to familiar administrative law constraints, as a practical matter, neither Congress nor the judiciary is likely to overrule its exercise of discretion in the international banking arena. In practice, legal power lies with the domestic regulators." Bhala, *supra* note 4, at 25.

⁶⁹ *Basle Accord*, *supra* note 7.

⁷⁰ See *infra* Part III (describing current regulations adopted by the Committee).

⁷¹ See Zaring, *supra* note 6, at 288.

⁷² "The Basle Committee operates in secret and has sought throughout its existence to maintain an unpublicized existence and a low profile." Zaring, *supra* note 6,

mittee is neither a national organization of any country, nor an official international regulatory agency like a United Nations committee or one created by treaty. Apart from its significance in regulating bank capital, the Basle Committee is redefining the field of international law. Most legal scholars would classify the Basle Committee as an "international financial regulatory organization" ("IFRO").⁷³ Such "organizations do not meet the traditional legal definition of an international organization, which applies only to organizations composed of states and constituted by formal treaty. IFROs nonetheless promulgate important legal rules and have successfully pursued sophisticated international cooperation."⁷⁴ While many international organizations, both traditional and non-traditional, have increased their membership to include representation from nations expressing interest, the Basle Committee has chosen to keep its circle exclusive. Although the Basle Committee has sought to "extend its 'influence' on a near global basis," it has also "made the conscious decision not to expand its membership beyond its original limited group."⁷⁵ The Basle Committee is truly a club of giants.

C. *The Basle Accord As "Soft Law"*

The Basle Committee lacks the authority to actually make law. The pronouncements of the Committee, however, are nearly always uniformly incorporated into the national regulatory regimes of the G-10 nations and many other countries around the world.⁷⁶ The process by which capital adequacy standards are devised and become law involves four major steps. First, the members of the Committee call the membership's attention to pressing issues in capital adequacy regulation and draft proposals for regulation. Second, the Committee issues Consultative Papers detailing its proposal to change capital standards and requests the submission of comments by governments, banks, academics, and other interested parties.⁷⁷ Most publications and Consultative Papers are available to the members of the general public via

at 288.

⁷³ *Id.* at 285.

⁷⁴ *Id.*

⁷⁵ NORTON, *supra* note 67, at 229.

⁷⁶ See *infra* Part III.D (discussing the implementation of capital adequacy standards and noting that the standards were adopted by statute in the United States, Europe, and eventually much of Asia).

⁷⁷ See *Bank for International Settlements* (last modified Jan. 2000) <<http://www.bis.org/contact.htm>> (giving instructions to interested parties on how to file comments concerning the Basle Committee's Consultative Papers).

the Basle Committee's portion of Bank of International Settlements' Internet site.⁷⁸ The upsurge of Internet users has pressured the Committee to unveil much of its activities and proposals directly to the public.⁷⁹ Third, the Committee collects the comments, evaluates them, and amends the Consultative Papers when necessary.⁸⁰ Fourth, the members unanimously agree to work to implement the standards in their respective countries. Thus, "[w]ithout in any way approaching the legal status of a treaty, . . . [an] agreement is considered to be binding on its members."⁸¹

The final step, implementation of the standards by members of the Committee, is what sets the Basle Committee apart from official international law-making bodies. Despite its lack of official law-making power, the Basle Committee is, in fact, the generator of international capital adequacy standards; home country enactment is simply a formality. The policies are essentially created by the members of this club of giants. Thus, some commentators have glibly referred to this new genre of legal species as "club" law.

Largely due to the prestige and institutional power of its membership, the regulatory standards that emanate under the Committee's auspices enjoy a far wider legitimacy than would be justified by their doubtful legal status. Through their *de facto* implementation by the represented institutions within the limits of their discretionary powers, but also through their formal adoption by national legislators, Committee pronouncements, despite their lack of formal force, exert in practice a very power-

⁷⁸ See *Bank for International Settlements* (last modified Apr. 19, 2000) <<http://www.bis.org/publ/index.htm>>.

⁷⁹ Before the growth of the Internet, the general public was often excluded from viewing the Committee's proposals. This was especially true during the drafting and promulgation process of the 1988 Accord:

[T]he Basle Committee issue[d] Consultative Papers to national central banks and banking supervisors, not to the international financial sector. Each central bank then determine[d] how comments [would] be collected domestically and transmit[ed] summaries of responses to the Basle Committee. This filtering of responses through national central banks was consistent with the Basle Committee's original mandate of providing a forum for discussion by bank regulators of domestic supervisory standards, because the focus was on regulations at the national level.

Barbara C. Matthews, *Capital Adequacy, Netting, and Derivatives*, 2 STAN. J.L. BUS. & FIN. 167, 189-90 (1995).

⁸⁰ This process is similar to the process of administrative rulemaking in the United States. See Administrative Procedure Act § 676, 5 U.S.C. § 553 (1994) (outlining the process of notice and comment for federal regulatory agencies).

⁸¹ Zaring, *supra* note 6, at 289 (quoting Charles Freeland, *The Work of the Basle Committee*, in 2 CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS 231, 233 (Robert C. Effros ed., 1994)).

ful influence in the generation of national and regional legal rules and formal institutional structures. The process could be described as the inculcation of formal legal systems by central bankers' "club" law.⁸²

Classifying this "multibillion-dollar global regulatory scheme" into a specific genre of legislative process is difficult. There are two principal reasons why the fourth step of the law-making process is more ceremonial than substantive. First, as mentioned above, central bankers enjoy a great deal of regulatory freedom.⁸³ Second, "[d]espite its insistence on informality, the Basle Committee has designed methods intended to compel its members to apply the regulations it promulgates to their banks upon their return from committee meetings."⁸⁴ The fraternal milieu of the Committee creates a certain degree of synergy among its members. This synergy, when combined with each representative's extensive rule-making power, results in an international convergence of national regulations.

Some scholars have emphasized the importance of the Basle Committee as a model for future regulatory reform, more precisely classifying its legal product as "soft law."⁸⁵ "Soft law refers to a set of legal terms or informal duties adopted under formal or informal treaties or multilateral agreements. The emergence of soft law resulted from the inadequacy of hard law, which cannot overcome deadlocks in international relations that result from economic or political differences."⁸⁶ Such soft law commitments are non-binding.⁸⁷ Officially, the documents issued by the Basle Committee are termed "Accords" or "Concordats," which illustrate their political importance, but divest them of binding legal authority.⁸⁸ At last, bank regulators hoping to create international capital adequacy standards could avoid the two recurring problems: the lack of cooperation among nations and the arduous process of instituting international laws. The solution was

⁸² Christos D. Hadjiemmanuil, *Central Bankers' "Club" Law and Transitional Economies: Banking Reform and the Reception of the Basle Standards of Prudential Supervision in Eastern Europe and the Former Soviet Union*, in EMERGING FINANCIAL MARKETS AND THE ROLE OF INTERNATIONAL FINANCIAL ORGANIZATIONS 179, 184 (Joseph J. Norton & Mads Andenas eds., 1996).

⁸³ See generally *supra* note 68 (describing the degree of latitude afforded the Federal Reserve by the U.S. Congress in promulgating capital adequacy standards).

⁸⁴ Zaring, *supra* note 6, at 290.

⁸⁵ Lee, *supra* note 37, at 7.

⁸⁶ *Id.* at 3-4.

⁸⁷ *Id.* at 7 ("Unlike a hard law which places obligations on members, a soft law places no legally binding duties on the signatories.").

⁸⁸ Matthews, *supra* note 79, at 184 ("These terms recognize that the documents are not treaties carrying the force of law.").

combining the dynamically unified Committee with the institution of soft law.

This combination permits "banks from different countries with different domestic banking regulations to work together under one set of international banking standards."⁸⁹ Despite its exclusivity, the Basle Committee, according to some scholars, has actually increased the forum for debating capital adequacy issues by equipping "the private sector with an additional opportunity to change parallel domestic regulation to which they are opposed."⁹⁰ Whether one likes or dislikes the process through which this club of giants regulates bank capital, it is evident that "expanding the role of the Basle Committee offers the possibility of reaching the goal of strengthening supervision of international banking worldwide without the imposition of a new legal framework or interference with national sovereignty."⁹¹ Consequently, the Basle Committee may be the model for future regulatory convergence of national economic laws. While the rule-making process of the Basle Committee may be a step toward progress for international financial regulation, the rules themselves clearly are not.

III. CURRENT CAPITAL ADEQUACY REGULATIONS

The current capital adequacy regulation is a codified version of the 1988 Basle Accord.⁹² When outlining the current capital adequacy rules, this Comment will cite to the 1988 Accord and U.S. regulations where relevant. The regulations of other nations are materially the same as U.S. regulations and the Accord.

A. *The Philosophy of the 1988 Basle Accord*

When the Basle Committee decided to initiate international convergence of capital adequacy standards, it sought to achieve two goals: (1) strengthening bank capital requirements to reduce credit risk,⁹³ and (2) leveling the playing field among member nations.⁹⁴ Achieving

⁸⁹ Lee, *supra* note 37, at 4.

⁹⁰ Matthews, *supra* note 79, at 187.

⁹¹ Lee, *supra* note 37, at 6.

⁹² See 12 C.F.R. § 208.4 (1999) (stating the U.S. regulations regarding bank capital adequacy).

⁹³ See *id.* § 208 app. A (noting that "[t]he risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance-sheet items to risk categories does incorporate elements of transfer risk, as well as limited instances of interest rate and market risk").

⁹⁴ See *Basle Accord*, *supra* note 7, ¶ 3 (stating that the first goal of the Accord is to

the second goal required uniform implementation of the rules throughout the member nations. Achievement of the first goal would involve more thought. The Basle Committee decided that, apart from uniformity, there were three major components of an effective capital adequacy regulatory regime.

The first component was an official risk weighting of assets.⁹⁵ Before that time, many nations simply required banks to allocate a percentage of their capital to all assets on an equal basis, regardless of the risks associated with the different loans and other asset types.⁹⁶ Consequently, two banks in the same country would have to hold the same amount of capital against a \$100,000,000 loan even if one bank loaned to the central government and the other to a risky "start-up" company. Banks argued that such non-risk-based capital requirements were unfair to those who prudently lent to safer borrowers. Without risk-based standards, banks had an incentive to loan to risky borrowers at higher rates of interest, since the capital required per asset dollar was the same no matter who the borrower.

Second, the Basle Committee introduced the concept of "regulatory" capital.⁹⁷ Regulatory capital consists simply of balance sheet items which regulators deem to be capital.⁹⁸ One major problem in international banking and finance is that national accounting methods vary significantly from one country to another.⁹⁹ This divergence in accounting standards resulted in various definitions of capital being used in different nations.¹⁰⁰ Thus, the universal adoption of a rule requiring a fixed percentage of capital, even when apportioned to assets on the basis of risk, would not alone ensure uniformity and stability since the same instrument could be classified as capital in one nation

"strengthen the soundness and stability of the international banking system").

⁹⁵ See *id.* ¶¶ 28-43 (outlining the weighted risk approach).

⁹⁶ See SCOTT & WELLONS, *supra* note 8, at 218 (noting "the practice of using a fixed percentage of the value of the asset regardless of its risk").

⁹⁷ See *Basle Accord*, *supra* note 7, ¶¶ 12-27 (discussing what constitutes the regulatory definition of capital).

⁹⁸ See *id.* ¶ 14 (defining regulatory capital as consisting of at least 50% "of equity capital and published reserves from post-tax retained earnings ([T]ier 1)" with the remaining elements consisting of supplementary capital (Tier 2)).

⁹⁹ See generally, R. FRANKEL & C. LEE, ACCOUNTING DIVERSITY AND INTERNATIONAL VALUATION (NYSE Working Paper No. 96-01, 1996) (discussing differences among national accounting methods); M. ZAFAR IQBAL ET AL., INTERNATIONAL ACCOUNTING: A GLOBAL PERSPECTIVE (1997) (same); Sir Bryan Carberg, Global Issues and Implementing Core International Accounting Standards: Where Lies IASC's Final Goal?, Address to the Japanese Institute of CPA's (Oct. 23, 1998) (same).

¹⁰⁰ See SCOTT & WELLONS, *supra* note 8, at 225 (noting that "[c]ountries differed so much in their definitions that it was essential to define capital").

and a liability in another. Furthermore, classification as regulatory capital is based less on the instrument's residual interest in the assets and more on its maturity date.¹⁰¹ A debt instrument, even a long-term bond, would normally be classified as a liability on a bank's balance sheet. After all, bonds are "debts or obligations of an entity that have arisen from past transactions."¹⁰² Since long-term bonds will not mature for a substantial period of time, however, they present no risk of current redemption. Therefore, even non-equity instruments can serve as regulatory capital, building the "financial cushion that absorbs banks' losses and thus protects depositors."¹⁰³ The Basle Committee posited that some forms of regulatory capital, especially common equity, form a stronger cushion than other forms because of their residual nature. Consequently, the Committee divided regulatory capital into two tiers—Tier I and Tier II—with restrictions placed on the amount of Tier II, the less residual capital, that could be included in the minimal legal cushion.¹⁰⁴

Third, the Basle Committee wanted to be certain that all activities exposing banks to credit risk¹⁰⁵ were incorporated in the determination of the amount of capital banks were required to hold. "During the early 1980s . . . commercial banks sought more business for which they could charge fees without generating liabilities or assets."¹⁰⁶ These activities, which do not require the posting of official journal entries to the balance sheet, are known as off-balance-sheet ("OBS") items.¹⁰⁷ Measures were taken to guard against the risks associated with the OBS items, such as applying credit conversion factors to these items so they could be treated in a similar manner as risk-weighted as-

¹⁰¹ Capital (owner's equity) is described as "[t]he amount of an owner's net investment in a business plus profits from successful operations which have been retained in the business." MEIGS & MEIGS, *supra* note 3, at 39.

¹⁰² *Id.*

¹⁰³ Shadow Proposal, *supra* note 11, at 1.

¹⁰⁴ See 12 C.F.R. § 208 app. A (1999) (discussing the specifics of Tier 1 and Tier 2 capital); *Basle Accord*, *supra* note 7, ¶ 14 (same).

¹⁰⁵ For a definition of credit risk, see *supra* note 21.

¹⁰⁶ SCOTT & WELLONS, *supra* note 8, at 230.

¹⁰⁷ Off-balance-sheet items are "[b]anks' business, often fee-based, that does not generally involve booking assets and taking deposits. Examples are trading of swaps, options, foreign exchange forwards, standby commitments and letters of credit." The Wharton Sch. of Bus., *supra* note 21, at 23; see also SCOTT & WELLONS, *supra* note 8, at 232 ("Off-balance sheet [sic] items are obligations of banks that may or may not be called, such as bank guarantees. These contingent liabilities depend on some action or event for the bank to pay.").

sets when apportioning capital.¹⁰⁸ In this manner, transactions affecting overall credit risk, but not the balance sheet, would be included in the assessment of bank capital necessary to sustain safe and stable operations. The Committee's twin goals of establishing risk-based capital standards and creating a level playing field are evident as the guiding principles of the technical rules that follow.

B. *The Required Capital Ratio*

Under the Basle Accord, the general rule is that all banks must maintain a ratio of 8% capital to the total amount of risk-weighted assets and credit-converted OBS items.¹⁰⁹ More specifically, capital is divided into Tier 1 and Tier 2. Tier 1 Capital "[m]ust equal or exceed 4% of weighted risk assets," including OBS conversions.¹¹⁰ The "[t]otal of Tier 2 [capital] is limited to 100% of Tier 1."¹¹¹ The Accord also requires the following items to be deducted from the sum of Tiers 1 and 2 before the ratio of 8% can be assessed: (1) "Investments in unconsolidated subsidiaries," (2) "Reciprocal holdings of banking organizations' capital securities," and (3) "Other deductions . . . as determined by [the] supervisory authority."¹¹²

The types of instruments comprising Tiers 1 and 2 and their specific restrictions are summarized below:

CORE CAPITAL (TIER 1)¹¹³

Common Stockholder's Equity – No limit

Qualified, noncumulative, perpetual preferred – No limit¹¹⁴

¹⁰⁸ See *infra* notes 120-21 and accompanying text (discussing the specifics of credit-conversion factors).

¹⁰⁹ See *Basle Accord*, *supra* note 7, ¶ 44 (explaining the general rule and the target standard ratio).

¹¹⁰ 12 C.F.R. § 208 app. A, attachment II (1999).

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ See *id.* (showing that "[g]oodwill and other intangible assets" must be deducted from the total of Tier 1).

¹¹⁴ There is no stated limit on noncumulative, perpetual preferred stock, but the Committee offered this caveat: "[B]anks should avoid undue reliance on preferred stock in Tier 1." *Id.*

SUPPLEMENTARY CAPITAL (TIER 2)¹¹⁵

<p>Allowance for loan and lease losses – Limited to 1.25% of weighted-risk assets</p> <p>Perpetual preferred stock – No limit within Tier 2</p> <p>Hybrid capital instruments and equity contract notes - No limit within Tier 2</p> <p>Subordinated debt and intermediate-term preferred stock – limited to 50% of Tier 1 (original weighted average maturity of 5 years or more)</p>
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Thus, the division of capital into two tiers illustrates that banking regulators have a preference for more residual instruments with a perpetual existence. The requirement that half of the ratio be composed of Tier 1 capital illustrates the Basle Committee's attempted preemptive strike against the misuse of capital definitions by highly leveraged banks. The individual restrictions within Tier 2 also establish the boundaries within which long-term debt instruments (subordinated debt and intermediate-term preferred stocks) and contra-assets (allowance for loan and lease losses) can be used to establish an adequate capital cushion. With a more precise definition of regulatory capital incorporated into the Accord, the Basle Committee felt reassured that the goal of achieving a level playing field could be more easily achieved.

C. *The Risk-Rating Rules*

Distinct from the problem of arriving at a universal definition of capital was the further complication that banks also possessed assets with varying degrees of credit risk. To avoid a single blanket risk of 100%, the Basle Committee separated the various loans and other assets into categories based on an approximation of risk.¹¹⁶ The risk categories for on-balance sheet assets are divided into four groups: 0%, 20%, 50%, and 100%.¹¹⁷ These four groups roughly correspond to the debt of "central governments, public sector entities, banks and

¹¹⁵ See *id.* Revaluation reserves were excluded from Tier 2 capital until October 1998, when less than 50% on specific gains were allowed. See SCOTT & WELLONS, *supra* note 8, at 224 (discussing the 1998 amendment allowing the inclusion of "up to 45% of pretax net unrealized holding gains").

¹¹⁶ See 12 C.F.R. § 208 app. A, attachment III (1999) (laying out the "Summary of Risk Weights and Risk Categories for State Member Banks").

¹¹⁷ See *id.* (delineating the various categories of risk for on-balance sheet assets).

non-bank corporates and for the first three of these certain distinctions are made between OECD¹¹⁸ and non-OECD counterparties.¹¹⁹ These risk-based assets were, as stated above, complemented by a list of credit-conversion factors used to assess the impact of a bank's OBS items.¹²⁰ "The conversion factors are applied to the nominal principal amount of exposure to produce a credit equivalent amount which in turn is weighted according to the category of the counterparty."¹²¹

In applying these extremely technical regulations, a bank must understand the basic equation for deriving its mandatory capital ratio. "A bank's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its weighted-risk assets (the denominator)."¹²² Therefore, one must first evaluate how much of the bank's capital qualifies as Tier 1. Once the total amount of Tier 1 regulatory capital is established, the bank can evaluate how much of its equity and long-term debt can comprise its Tier 2 holdings, since the amount of certain instruments in Tier 2 are limited to a fixed percentage of Tier 1. Moreover, the entire dollar amount of Tier 2 cannot exceed that of Tier 1. Once the numerator is established, one next identifies the value of the bank's weighted-risk assets through a three-step process. First, all assets on the balance sheet must be individually multiplied by the percentage of their corresponding risk category and then summed. Second, all OBS items must be individually multiplied by their respective credit-conversion factor and then summed. Third, both sums are added together, resulting in the total risk-weighted assets (denominator), which encompasses bank activities on and off the balance sheet. Finally, the bank's calculated regulatory capital is divided by the total amount of risk-weighted assets and activities. This result is a decimal that is converted into a percentage. The bank must have an 8% ratio or higher to satisfy the standards of the Basle Accord.

¹¹⁸ The OECD is the:

Organization for Economic Co-operation and Development. Its members are Austria, Belgium, Canada, Denmark, Finland, France, West Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

The Wharton Sch. of Bus., *supra* note 21, at 22.

¹¹⁹ PETER COOKE, *BANK CAPITAL ADEQUACY AND CAPITAL CONVERGENCE* 6 (1991).

¹²⁰ See 12 C.F.R. § 208 app. A, attachment IV (1999) (laying out the "Credit Conversion Factors for Off Balance-Sheet Items for State Member Banks").

¹²¹ COOKE, *supra* note 119, at 6.

¹²² 12 C.F.R. § 208 app. A (1999).

Once a bank's capital ratio reaches 8% of risk-rated assets and credit-converted OBS items, the bank may still be required to add more capital to its cushion. "The risk-based capital guidelines establish *minimum* ratios of capital to weighted-risk assets."¹²³ The Federal Reserve has stated:

[T]he final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio. . . . [B]anks generally are expected to operate well above the minimum risk-based ratios. In particular, banks contemplating significant expansion proposals are expected to maintain strong capital levels substantially above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans.¹²⁴

Thus, the Basle Accord resulted in an international standard that set a baseline capital cushion for commercial banks, but also provided subscribing nations with a significant degree of discretion to impose additional requirements.

D. Implementation of Basle Capital Adequacy Standards

Once the Committee's members agreed on the technical risk-weighted methods forming the Basle Accord, each representative bore the responsibility of incorporating the new standards into the regulations of his home country.¹²⁵ In the United States, the Federal Reserve immediately issued regulations mirroring the Accord.¹²⁶ At the time of their adoption, the standards, which were converted into new regulations, encountered little resistance from the U.S. Congress or the federal judiciary. In fact, further adjustments and enforcement of the promulgated capital adequacy standards have been bequeathed solely to the Federal Reserve:

Most judges and congresspersons, however, pay little attention to, and have little knowledge of, international banking law. It is likely that many are unaware of the [Basle Committee's] existence and importance, and few know much about Federal Reserve functions aside from setting and implementing monetary policy. Capital adequacy rules are sure to appear byzantine to judges and congresspersons, and, unless widespread

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ See *supra* Part II.C (discussing the process by which the Basle standards become law).

¹²⁶ See 12 C.F.R. § 208 (1988) (outlining the first regulations promulgated in accordance with the new Basle standard).

public confidence in the banking system is at stake, they will not boost the re-election prospects of legislators.¹²⁷

Central bankers in countries other than the United States also easily incorporated the Basle standards into their respective regulatory regimes. The Accord was adopted promptly in Europe. In the United Kingdom, the Bank of England promulgated capital adequacy standards akin to those in the Accord.¹²⁸ Representatives on the Basle Committee who were members of the European Community ("EC")¹²⁹ prompted "two capital adequacy directives"¹³⁰ that were issued by the Council of Ministers in 1988: the Own Funds Directive¹³¹ and the Solvency Ratio Directive.¹³² "The Directive on Solvency Ratios constrains the own funds of a credit institution to at least 8% of its risk-weighted assets."¹³⁴ Member nations of the EC were legally bound to adopt the standards specified in the Directives by promulgating national banking regulations by a specified date.¹³⁵ After the United States and Europe implemented the Basle standards, many other nations would be pressured into adopting the Accord as well. An informal process exists whereby "Basle members challenge non-Basle members, whose banks want to do business in Basle members' countries, to adopt the Basle Accord's principles."¹³⁶ Within a few short

¹²⁷ Bhala, *supra* note 4, at 23.

¹²⁸ See *Convergence of Capital Adequacy in the UK and US*, 27 BANK ENG. Q. BULL. 85 (1987) (highlighting the Bank of England's preemptive adoption of the Basle Accord before its final issuance in 1988).

¹²⁹ The European Community is "[n]ow known as [the] EU or European Union." SCOTT & WELLONS, *supra* note 8, at 1236.

¹³⁰ "An EC directive creates a general binding obligation upon member states, but it leaves to each state the means by which to fulfill the obligation." Alford, *supra* note 26, at 205.

¹³¹ See Council Directive 89/299 of 17 April 1989 on the Own Funds of Credit Institutions, 1989 O.J. (L 124) 16.

¹³² See Council Directive 89/647 of 18 December 1989 on a Solvency Ratio for Credit Institutions, 1989 O.J. (L 386) 14; see also Michael Gruson & Wolfgang Feuring, *The New Banking Law of the European Economic Community*, 25 INT'L LAW. 1, 28 (1991) ("The Solvency Ratio Directive represents the EEC's version of the capital adequacy rules of the Basle Committee on Banking Regulations and Supervisory Practices . . .").

¹³³ Alford, *supra* note 26, at 205.

¹³⁴ PHILIP MOLYNEUX ET AL., EFFICIENCY IN EUROPEAN BANKING 24 (1996) (citations omitted). "The capital adequacy requirements established by the Directive are in line with the Bank for International Settlements (BIS) proposals." *Id.*

¹³⁵ See *supra* note 130 (describing the binding effect of European Community Directives on member nations).

¹³⁶ Lee, *supra* note 37, at 32-33. "The Basle Accords have become the standard for international financial services regulations throughout the industrialized world. Banking institutions in non-Basle member countries that wish to do business with Basle

years, the Basle standards had spread to the banks of non-G-10 countries.

Several countries in Asia were the first non-G-10 countries to incorporate the risk-weighted capital ratios into their national banking regulations.¹³⁷ Commercial banking authorities in East Asia also mandated the Basle standards. Hong Kong, which has nearly always been an international financial center, adopted the Basle Accord after the Hong Kong Monetary Authority ("HKMA") decided incorporating the new standards would be beneficial to the state.¹³⁸ In 1997, when the Asian financial crisis was at its pinnacle, the International Monetary Fund¹³⁹ suggested to some countries that adoption of the Basle standards would help bring stability to their national banking systems. "[U]nder the IMF-supported reform program, Korea pledged . . . to set a timetable for all [of its] banks to meet or exceed Basle standards on capital adequacy"¹⁴⁰ Some nations, such as Singapore, adopted the basic standards of Basle but increased the capital ratio to provide a greater capital cushion against credit risk. "[T]o maintain the financial soundness of locally-incorporated banks, local banks were statutorily required to maintain a minimum Tier-1 capital adequacy ratio of twelve percent even though the [Basle Accord] was set at eight percent (based on Tier 1 and Tier 2)."¹⁴¹

The advancement of the Basle standards in Asia has led former

member countries are likely to comply with the Basle Accords." *Id.* at 5.

¹³⁷ For example, "India adopted them as part of the financial reforms package in 1992." S. Venkitaramanan, *Basle Revisits Risks*, BUS. LINE (Hindu), July 5, 1999, available in 1999 WL 21232504.

¹³⁸ See Berry Fong-Chung Hsu, *Legislative Control of Hong Kong Financial Markets: Some Aspects of Banking and Securities Regulations*, 28 LAW & POL'Y INT'L BUS. 649, 676 (1997) (noting that the Basle Accord is the new capital adequacy regime in Hong Kong and reporting that "[a]ll authorized institutions incorporated in Hong Kong must maintain a capital adequacy ratio of eight percent, as calculated in accordance with the provisions of the Third Schedule of the Banking Ordinance"); see also Lawrence L.C. Lee, *Adoption and Application of a "Soft Law" Banking Supervisory Framework Based on the Current Basle Accords to the Chinese Economic Area*, 16 WIS. INT'L L.J. 687, 711 (1998) ("In supervising banks, the HKMA follows international practices as recommended by the Basle Accords—for example, the capital adequacy framework and the minimum standards for supervision of international banking groups.").

¹³⁹ The International Monetary Fund ("IMF") is an "[o]rganization founded at Bretton Woods in July 1944, and located in Washington, D.C., with the goal of overseeing exchange arrangements and lending foreign currency reserves to members." The Wharton Sch. of Bus., *supra* note 21, at 16.

¹⁴⁰ John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J.L. & PUB. POL'Y 70, 80 (1998).

¹⁴¹ Ashish Lall & Ming-Hua Liu, *Liberalization of Financial and Capital Markets—Singapore Is Almost There!*, 28 LAW & POL'Y INT'L BUS. 619, 645 (1997).

communist nations to integrate the standards into their new capital adequacy regulations. Even the somewhat isolated Republic of Kazakhstan, formerly part of the Soviet Union, has recently implemented the standards.¹⁴² The following chart summarizes the implementation of the Basle Accord around the world:

IMPLEMENTATION OF CAPITAL ADEQUACY STANDARDS¹⁴³

Basle Committee	United States	European Union	Non-G-10 Countries
Total capital to risk-weighted assets at least 8%	Basle standards plus a leverage ratio of 4% at a minimum	Compulsory, at least 8% total capital to risk-weighted assets	Tend to adopt the Basle 8% standard, even when it is inappropriate because of volatility

When the Basle Accord was assembled in 1988, members of the "club of giants" likely had no idea that their capital adequacy standards would become so far-reaching. This is especially remarkable for standards that were simply a gentlemen's agreement among a small group of central bankers and never ratified into international law. Even though the Basle countries "are not legally bound, the Basle Accords' methodology now applies to virtually all financial institutions worldwide."¹⁴⁴ The Basle methodology has become the international capital adequacy standard, but it has not become a widely laudable standard.

E. *The Seven Deadly Sins of the 1988 Accord*

The current capital adequacy standards contain at least seven major flaws. First and most importantly, the Basle Accord establishes a regime that inaccurately micromanages bank risks categorically. Sec-

¹⁴² See Decree of the President of the Republic of Kazakhstan, "Law on Banks and Banking Activity in the Republic of Kazakhstan," art. 42 (adopting the Basle Accord into the national banking regulation of Kazakhstan). "The [National Bank of the Republic of Kazakhstan's] implementation of prudential normative regulations sets forth, among other things, a minimum capital level substantially in accordance with the Basle Committee's Accord on Capital Adequacy." Gary A. Gegenheimer, *Bank Regulatory Reform in the Republic of Kazakhstan*, 17 ANN. REV. BANKING L. 153, 184-85 (1998).

¹⁴³ The following chart is replicated from Lee, *supra* note 37, at 29.

¹⁴⁴ *Id.* at 6.

ond, nations still disagree with one another on the definition of "regulated capital." Third, the Basle Committee adopted a capital ratio of 8% without offering any empirical justification for the figure. Fourth, the Accord presumes that equity serves as an inherently better cushion than debt. Fifth, capital adequacy standards as designed by the Committee have not adequately leveled the playing field among nations. Sixth, the measure of risk-based assets ignores risk reduction caused by diversification. The final flaw is that the Basle rules are too simplistic and rigid to adequately govern the complex world of banking.

When the Basle Committee members designed the risk-based asset weightings, they sought to incorporate the reality that banks possessed assets at varying degrees of credit risk. The Committee's apportionment of all assets into one of four risk categories was rather coarse.¹⁴⁵ This method's obvious defect is that loans within the same risk categories will never exactly possess the same amount of credit risk. For example, unsecured loans to businesses are uniformly rated as having a 100% risk.¹⁴⁶ "Under the system currently in force, loans to IBM and to the corner news agent are assigned the same degree of risk."¹⁴⁷ Clearly, the degree of credit risk that each loan represents varies broadly from business to business. Companies that work to improve their financial stability, therefore, are not rewarded but instead penalized by the Basle Accord. The identical problem exists in the 0% category (and in all categories). Although the OECD countries¹⁴⁸ are a diverse group of nations with uneven degrees of economic stability, loans to OECD national governments are uniformly assessed as presenting no risk of default.¹⁴⁹ Thus, "all OECD sovereign borrowers attract a zero risk weighting, putting countries like Korea on a par with the US."¹⁵⁰ A second component of this defect is that risk weights among the various categories are often disproportionately inaccurate. For example, an unsecured loan to the Microsoft Corporation is currently deemed twice as risky as a family mortgage.¹⁵¹ Such a result

¹⁴⁵ See *supra* Part III.C (detailing the current risk-weighted asset categories promulgated through the Basle Accord).

¹⁴⁶ See 12 C.F.R. § 208 app. A, attachment III (1999) (detailing the types of assets classified in the 100% risk category).

¹⁴⁷ Jules Stewart, *Another Reason for Banks To Make Friends of Credit-Worthy*, FIN. DIRECTOR, Sept. 17, 1999, available in 1999 WL 2027705.

¹⁴⁸ See *supra* note 118 (listing the member nations of the OECD).

¹⁴⁹ See 12 C.F.R. § 208 app. A, attachment III (detailing the types of assets classified in the 0% risk category).

¹⁵⁰ *Basle Reforms Overdue*, FIN. NEWS, Oct. 7, 1999, available in 1999 WL 24779976.

¹⁵¹ An unsecured loan to a business would be rated as having a 100% risk. A mort-

seems rather absurd, but it is currently the law. This first flaw of the Basle Accord, the inaccurate, categorical assessment of asset risks, has led to two major problems, the second stemming from the first.

This first flaw of the Basle Accord has encouraged banks to engage in what commentators refer to as "regulatory arbitrage." Arbitrage is generally the "simultaneous purchase and sale or lending and borrowing of two assets or two groups of equivalent assets in order to profit from a price disparity."¹⁵² In a perfectly competitive environment, if two loans bear the same amount of overall risk, the interest rates charged on the two loans would be equal. Since capital adequacy regulations require a certain amount of capital to be held as a cushion against each loan, there is the possibility that two loans of equal risk could be assessed at different risk levels and thus be placed in separate categories. Moreover, if the risk weight assigned to one loan is far below its inherent risk, the bank will replace this asset with a higher yielding loan requiring the same or less regulatory capital. Thus, a "bank may engage in costly 'regulatory arbitrage' to effectively evade the regulatory capital requirement."¹⁵³ This regulatory arbitrage is accomplished by "swapping high risk-weight assets for low risk-weight assets."¹⁵⁴ Therefore, the Basle Accord may have actually provided incentives for banks to take more risks rather than curb perilous risk taking.¹⁵⁵

This sort of regulatory arbitrage strongly contributed to an international "credit crunch" in the United States¹⁵⁶ and subsequent finan-

gage securing a single-family home is rated at having only a 50% risk of default. See 12 C.F.R. § 208 app. A, attachment III (detailing the types of assets classified in the 100% and 50% risk categories).

¹⁵² The Wharton Sch. of Bus., *supra* note 21, at 1.

¹⁵³ Mingo, *supra* note 34, at 51.

¹⁵⁴ Alford, *supra* note 26, at 216.

¹⁵⁵ See RICHARD DALE, INTERNATIONAL BANKING DEREGULATION: THE GREAT BANKING EXPERIMENT 170 (1992) ("[B]ecause the riskiness of a bank's assets is no longer reflected in the cost or availability of its funding, the propensity for risk-taking by banks has greatly increased."); David Jones & John Mingo, *Industry Practices in Credit Risk Modeling and Internal Capital Allocations: Implications for a Models-Based Regulatory Capital Standard*, ECON. POL'Y REV. FED. RESERVE BANK N.Y., Oct. 1998, at 53, 54 ("[C]apital arbitrage stems from the disparities between true economic risks and the 'one-size-fits-all' notion of risk embodied in the Accord."); Mingo, *supra* note 34, at 51 ("[I]f a bank acts to maintain a chosen insolvency probability, requiring it to hold more capital may lead the bank to hold riskier assets sufficient to exactly offset the additional capital and leave insolvency probability unchanged."); *Basle Reforms Overdue*, *supra* note 150 ("The crude weighting system applied to different types of lending is often incentivising banks to assume risk. For instance, the rules make it attractive to lend short-term to other banks.").

¹⁵⁶ "As the Basle Accord became final in 1992, a slowdown in bank lending seemed

cial crises in Asia and Central America.¹⁵⁷ Most Americans are employed by private enterprises in one form or another. Generally, when American businesses thrive, the national economy also prospers. To finance their operations, many businesses incur debt in the form of bank loans. Since the Basle Accord decreed that business loans bear a weighted-risk of 100%, banks are deterred from loaning to private enterprises because they can loan to central governments by purchasing sovereign debt and hold no capital against such assets.¹⁵⁸ Businesses are therefore forced to either pay more for bank loans¹⁵⁹ or find alternative means of financing their operations.

[The Basle rules] have forced banks to shift the assets they hold in their portfolios. In the early 1990s banks reduced their commercial loans and raised their treasury holdings. This resulted in a corresponding decrease in the number of borrowers who were able to obtain loans. Large companies are not seriously harmed from this decline in credit because they have the option of issuing commercial paper. Rather, consumers and small businesses, that portion of the economy that represents half the gross domestic product and constitutes the principal source of job creation, suffer.¹⁶⁰

Many government officials conceded that Basle standards had a negative effect on the business and consumer lending market, further contributing to the economic downturn.

Richard C. Breeden, then chairman of the SEC, and William Isaac, a former chairman of the Federal Deposit Insurance Corporation (FDIC), suggested that the Basle Committee was partially responsible for the recession of the early 1990s. Breeden and Isaac claimed that the committee's bank capitalization requirements had so restricted credit that "it is hardly surprising the economy cannot seem to pull itself out of recession."¹⁶¹

to be creating or intensifying a recession in the U.S. and other industrial countries." SCOTT & WELLONS, *supra* note 8, at 233.

¹⁵⁷ See *infra* text accompanying notes 162-66.

¹⁵⁸ See 12 C.F.R. § 208 app. A, attachment III (1999) (detailing the types of assets classified in the 0% and 100% risk categories); Albrecht & Smith, *supra* note 21, at 417 ("Corporate loans are relatively expensive items, in terms of capital, to hold on a bank's balance sheet, because they are risk-weighted at one hundred percent, irrespective of the actual credit quality of the counterparty.").

¹⁵⁹ "[T]he Accord encouraged banks to invest in government bonds, with zero risk weight and therefore no capital cost, rather than lend to commercial and consumer borrowers subject to as much as 8% capital." SCOTT & WELLONS, *supra* note 8, at 233; see also R. Litan, *Nightmare in Basle*, INT'L ECON., Nov.-Dec. 1992, at 7 (discussing how much more expensive it is for a bank to loan to a company in contrast to purchasing a government bond under the Basle rules).

¹⁶⁰ Conroy, *supra* note 14, at 2431-32 (footnotes omitted).

¹⁶¹ Zaring, *supra* note 6, at 284 (quoting Richard C. Breeden & William N. Isaac,

Though many initially believed the risk-weighted categories would heal wounds in the international banking system by providing a more universal capital cushion, the Accord had the effect of becoming a tourniquet around the neck of the American economy. The United States, however, was not the only country to feel the ill effects of this first major flaw of the Basle Accord.

Some commentators attribute the further agitation of financial calamities in Asia to the risk-weighted specifications of the Accord. Although the Committee felt that risk weights were the "most workable proxy"¹⁶² for identifying the broad range of risks facing G-10 banks at the time, no account was taken of differences between the G-10 economies and the other economies that eventually would be pressured into adopting the Accord. As a result of Asian nations' typically dense populations, Asian real estate markets are different from those in the United States or Western Europe. Although the Basle Committee determined the risk rate for real estate mortgages to be 50%, markets such as Hong Kong mortgages are more than four times as risky as those in the United States.¹⁶³ "Even a risk factor of 200% may not be unreasonable."¹⁶⁴ Nevertheless, the lower-than-market risk weights assigned to mortgages provided incentives for Hong Kong banks and other Asian banks to make higher-yielding, riskier loans, while remaining effectively undercapitalized. The conclusion is that "the collapse of some Hong Kong banks is attributed to their heavy investment in the high risk and extremely volatile real estate market."¹⁶⁵

The Mexican peso crash was also facilitated by the inaccurate risk-based categories of the Basle Accord. Since Mexico became an OECD country, its central government's financial obligations were determined to be risk-free. Now that banks could make high interest loans to the Mexican government (by purchasing sovereign debt) without allocating any corresponding capital to their balance sheets, regulatory arbitrage was again encouraged.

Mexico's membership in the OECD merits particular attention The Basle Accord put a zero weighting on credit risk for the central government debt of all OECD countries, which by mid-1994 included Mexico. Therefore, at the time of the Mexican peso crash, banks from around

Thank Basle for the Credit Crunch, WALL ST. J., Nov. 4, 1992, at A14).

¹⁶² *New Framework*, *supra* note 10, annex 2, ¶ 3.

¹⁶³ See Hsu, *supra* note 138, at 676 ("While the risk weight for residential mortgages is fifty percent, this level is not suitable in the Hong Kong environment where the real estate price is unrealistically high and quite speculative.").

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

the globe could hold Mexican government debt securities without providing any capital reserves for credit risk.¹⁶⁶

Thus, the risk-weighted categories of the Accord have caused some of the very imprudent behavior which they were designed to prevent.

The second flaw of the Basle Accord is its failure to end disagreements among nations regarding the appropriate definition of "regulatory capital." Some nations favor rules restricting regulatory capital to equity instruments, while others prefer including more debt with less residual attributes in the ambit of regulatory capital.¹⁶⁷ The current classification of capital into Tier 1 and Tier 2 leaves countries some room to squeeze such preferences into the balance sheets of their respective commercial banks. The Committee's definition of Tier 2 especially "allows national regulators to include various forms of quasi-equity in their individual definition of bank capital."¹⁶⁸

The Accord's definition of capital is also overly broad in that it construes Tier 1 capital as incorporating common stock and "[q]ualifying non-cumulative *perpetual* preferred stock."¹⁶⁹ Since Tier 1 capital is required to be 4% or more of the bank's risk-weighted assets, banks of every nation have been attempting to get various equity instruments to qualify. For example, although perpetual is a synonym for eternal, "most banks have structured . . . offerings . . . with a maturity of 20 or 30 years" to fit within the realm of Tier 1.¹⁷⁰ Deutsche

¹⁶⁶ Timothy A. Canova, *Banking and Financial Reform at the Crossroads of the Neoliberal Contagion*, 7 U.S.-MEX. L.J. 85, 106 (1999).

¹⁶⁷ Even nations represented on the Basle Committee failed to reach a true consensus on the definition of "regulatory capital":

The Germans regarded the broadening by the [Basle] Committee of any definition beyond shareholders' equity as undermining the rigor of German capital requirements. France, which had a number of state-owned banks that would have found it difficult to increase shareholders' equity, argued for including a substantial amount of subordinated debt in the definition. The United States, which had counted loan loss reserves as part of regulatory capital, argued that such a practice should be continued. The Japanese, whose banks had substantial unrealized capital gains in securities holdings, argued that such gains should be counted as assets and, hence, as higher equity.

Statement No. 160, supra note 11.

¹⁶⁸ Alford, *supra* note 26, at 203.

¹⁶⁹ 12 C.F.R. § 208 app. A, attachment II (1999) (emphasis added); *see also supra* Part III.B (outlining the components of Tier 1 capital).

¹⁷⁰ *Deutsche Reopens Tier 1 Capital Issue*, INT'L BANKING REG., Feb. 9, 1998, at 1; *see also* Arturo Estrella, *Formulas or Supervision? Remarks on the Future of Regulatory Capital*, ECON. POL'Y REV. FED. RESERVE BANK N.Y., Oct. 1998, at 191, 191 (describing the "risk of an increasing disconnect between regulatory capital and what banks and other fi-

Bank, the world's largest bank, made an even more daring attempt in its recent offering of a new brand of preferred stock that closely resembled a long-term debt instrument.¹⁷¹ The stock "has a final maturity of only 10 years, with no call options."¹⁷² The German government seems to approve of the offering, probably because it will give German banks an advantage over other nations' banks offering more perpetual equity. While ten years does not seem to fall within the realm of "perpetual," the Deutsche Bank offering shows how bold bankers are constantly testing the waters of Tier 1. With both commercial banks and their regulators manipulating Tier 1 to encompass less residual equity, one wonders whether the Basle definition of regulatory capital is not completely vacuous.

A third major criticism of the Basle Accord is that the 8% capital ratio requirement has little or no grounding. In fact, many nations, including the United States, have made special provisions to raise the 8% ratio either in specific cases or on a universal basis.¹⁷³ The 8% figure may not be trustworthy because "regulatory measures of 'capital' may not represent a bank's true capacity to absorb unexpected losses."¹⁷⁴ Why should the ratio be 8% and not 6%, or even 10%? Unfortunately, the Basle Committee has left the world with little justification for its choice. Indeed, "[t]he 8% minimum is not grounded in any financial model of capital adequacy. Not only has the [Basle] Committee failed to explain why 8% is the right minimum total capital ratio, it has never defined the question to which 8% is the answer."¹⁷⁵ This ambiguity has led to a mixed result. Countries have either individually mandated a higher ratio or collectively ignored the current, arbitrary ratio. Moreover, studies conducted with the most reliable credit risk models have shown that a typical bank may be concurrently over-capitalized from the regulators' point of view, but inadequately capitalized from a market standpoint.¹⁷⁶ The first flaw of

nancial institutions do").

¹⁷¹ See *Deutsche Reopens Tier 1 Capital Issue*, *supra* note 170, at 1 (describing the new equity offering Deutsche Bank hoped to qualify as Tier 1).

¹⁷² *Id.*

¹⁷³ See 12 C.F.R. § 208 app. A (stating that the Federal Reserve has the ability to increase the capital ratio when it considers such action necessary); Lall & Liu, *supra* note 141, at 645 (discussing how Singapore adopted the basic standards of Basle, but increased the capital ratio to provide even more of a capital cushion against credit risk).

¹⁷⁴ Jones & Mingo, *supra* note 155, at 53.

¹⁷⁵ Shadow Proposal, *supra* note 11, at 21.

¹⁷⁶ See Mingo, *supra* note 34, at 51 ("From a regulatory perspective the [hypothetical] bank is 'well-capitalized;' but from an economic perspective the bank is undercapitalized by nearly 3 percentage points.").

the Basle Accord, inaccurate risk categories producing, *inter alia*, regulatory arbitrage, further exacerbates this third defect.¹⁷⁷

The fourth flaw of the current capital adequacy regime is its deep-seated presumption that equity serves as an inherently better cushion than debt. Equity is thought to serve as a better capital cushion mainly because debt is intrinsically a liability. Unlike common equity instruments that represent a perpetual and residual interest in the bank's assets, debt instruments must eventually be repaid. The result is that the same long-term debt instrument could serve as a capital cushion for part of its life and then become a liability as it nears maturity. From this standpoint, debt is a less solid cushion for ensuring that a bank's capital is adequate to withstand realized credit risk. This argument, however, may be more academic than pragmatic.

Since capital adequacy regulation aims to encourage bankers to act with sound judgment¹⁷⁸ and not imprudently increase their risks, debtholders, rather than equity shareholders, may have more incentives to insist that bankers do not issue risky loans. Debtholders receive only the price of their debt at the time of payment by the bank. Equity holders, on the other hand, stand to gain wealth through dividends and higher stock prices. If the bank makes risky loans and becomes insolvent, both debtholders and shareholders lose. If, however, the bank successfully obtains higher yields on riskier assets, shareholders will gain directly from such yields. Debtholders, in contrast, will gain nothing more than their original entitlement to the face value of the debt plus accrued interest.¹⁷⁹ Therefore, debtholders have more incentive than equity owners to ensure that commercial banks act more prudently in their capacity as risk takers.¹⁸⁰

The fifth defect in the Basle Accord is that its goal of leveling the playing field among nations can never be achieved by such a regulatory structure.¹⁸¹ This unlikelihood results from the immense variance

¹⁷⁷ See Jones & Mingo, *supra* note 155, at 53 ("The basic problem is that securitization and other forms of capital arbitrage allow banks to achieve *effective* capital requirements well below the *nominal* 8 percent Basle standard.").

¹⁷⁸ See *supra* Part I.C (discussing the reasons for capital adequacy regulation by the government). Regulators have decided that they do not fancy "major banks operating with such a high default probability." Mingo, *supra* note 34, at 53.

¹⁷⁹ "The temptation shareholders sometimes face to profit at the expense of debtholders by increasing asset risk is known as the 'asset substitution' problem . . ." Shadow Proposal, *supra* note 11, at 30 n.18.

¹⁸⁰ See *infra* Part V.A (discussing the impact of debtholders on capital adequacy regulation and the basics of the subordinated debt requirement of the Shadow Committee Proposal).

¹⁸¹ Professor Hal Scott of Harvard Law School has even remarked that "it would be

of supplementary regulations, customs, and market structures that continue to position nations on uneven playing fields. Indeed, "the Basle Accord *could not* appreciably even the playing field between United States and foreign banks. Other, more powerful factors are at work that distort this competition."¹⁸² One of those more powerful factors is whether nations maintain insurance systems that bail out insolvent banks. Countries that are much more generous in bailing out commercial banks create greater incentives for banks to take on more risk.¹⁸³ Since "the strength of safety nets differs among countries," little leveling can really be accomplished.¹⁸⁴ Another major divide among countries is the degree of diversity among financial instruments. Even between the United States and its financially sophisticated peers in Europe, certain types of equity do not coexist on both continents. For instance, "European banks do not generally issue non-cumulative perpetual preferred stock."¹⁸⁵ Since non-cumulative perpetual preferred stock can be used to satisfy the Tier 1 regulatory capital requirements,¹⁸⁶ U.S. banks are clearly at a competitive advantage vis-à-vis their European counterparts.¹⁸⁷ Other differences among nations that are purely market-based, such as comparative advantages in housing and other industries, can also affect bank lending habits.¹⁸⁸ These obvious variances between nations are unlikely to change in the next few years.

an accident if the Accord evened the playing field." Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, 39 ST. LOUIS U. L.J. 885, 891 (1995).

¹⁸² *Id.* at 886; see also MAXIMILIAN J.B. HALL, BANKING REGULATION AND SUPERVISION: A COMPARATIVE STUDY OF THE UK, USA AND JAPAN 183 (1993) ("Despite common objectives and the pressures created for convergence in regulatory and supervisory practice, the regulatory and supervisory regimes currently in place in the UK, USA and Japan are likely to retain a significant degree of distinctiveness for a considerable time to come.").

¹⁸³ See *supra* note 38 (mentioning the moral hazard created by deposit insurance regimes).

¹⁸⁴ Scott, *supra* note 181, at 887.

¹⁸⁵ *Id.* at 892.

¹⁸⁶ See 12 C.F.R. § 208 app. A, attachment II (1999) (ascribing "no limit" on the amount of non-cumulative perpetual preferred stock included in Tier 1).

¹⁸⁷ See Scott, *supra* note 181, at 892 ("Insofar as this results in foreign banks using more expensive forms of capital, they are at a competitive disadvantage with U.S. banks which make significant use of such instruments."). The Japanese also lack the ability to incorporate certain types of equity into their required regulatory capital. See *id.* ("Japanese banks have not been able, due to legal impediments, to take advantage of the Basle rules permitting the use of preferred stock.").

¹⁸⁸ See *id.* at 893 (explaining, for instance, that "there is less financing of residential real estate in Japan due to different housing conditions").

Whatever the outcome of international agreements—multilateral or bilateral—and irrespective of differences in legal and fiscal systems, institutional structure or accounting conventions, national differences in approach will always exert a powerful influence on the fortunes of internationally active banks and the stability of the international banking system because of the degree of discretion which will always reside with national governments and regulatory authorities.¹⁸⁹

Because there are so many other variables in the equation of equalization, the Basle Accord's mere contribution of capital adequacy standards was too weak to level the playing field—and perhaps may have made the field more uneven for some.

The sixth major error of the Basle Accord is that it ignores diversification when calculating the total risk-based assets by which the amount of qualifying capital is divided. Diversification is the "process of investing in a number of different assets."¹⁹⁰ In practical terms, "diversification allows investment in riskier individual securities by reducing risk exposure to a portfolio by such individual assets. In this way, higher returns can be pursued without incurring all the risk of a single risky asset."¹⁹¹ Instead of using diversification to adjust the total risk-weighted assets, the current standards simply require that once assets are individually multiplied by their corresponding categorical risk, they are collectively summed. Thus, the Basle Accord overlooks the widely accepted theory of portfolio valuation. Again, the result is more inaccuracy in the determination of the true risk of bank assets and activities.

The final flaw in the Basle Accord is that it was narrowly designed to only address the credit risk generated by bank loans and a few OBS items. The bread and butter of commercial banking is still loaning to borrowers from funds generated from the deposits of savers. The recent revolution in financial products, however, has allowed banks to add more lucrative treats to their plates, especially in the form of de-

¹⁸⁹ HALL, *supra* note 182, at 183-84.

¹⁹⁰ ROBERT C. HIGGINS, *ANALYSIS FOR FINANCIAL MANAGEMENT* 375 (4th ed. 1995).

¹⁹¹ Phillips & Rechtschaffen, *supra* note 40, at 1765. "An asset's risk in isolation is greater than its portfolio risk whenever the asset's cash flows and the portfolio's cash flows are less than perfectly correlated." HIGGINS, *supra* note 190, at 317. When this usual event occurs, "some of the asset's cash flow variability is offset by variability in the portfolio's cash flows, and the effective risk the investor bears is reduced." *Id.* at 317-18; see also A. James Meigs, *The Financial System*, in *HANDBOOK OF MODERN FINANCE* 1-1, 1-5 (Dennis E. Logue ed., 1984) ("Diversification through financial institutions and markets permits investors to hold a variety of assets whose prices are not tied to one another. Therefore, as a matter of random chance, losses on some assets should be offset to some degree by gains on others.").

derivatives. "[B]anks continue to shift away from traditional deposit taking and lending and now derive substantial revenue and profit from derivatives."¹⁹² Derivatives are odd creatures involving hedging and speculation. "[A] derivative instrument is a financial contract which derives its value from an underlying asset, reference rate, or index."¹⁹³ The four major types of derivatives are options, forwards, futures, and swaps.¹⁹⁴ The most common derivatives held and issued by commercial banks are swaps. "[T]he underlying principle of a swap is the agreement of each of two parties to provide the other with a series of cash flows, based on fixed or floating interest rates and in the same or different currencies."¹⁹⁵ When the Basle Accord was first instituted, the swap and its kin in the derivative family fell into a general category of OBS items.¹⁹⁶

The problem with swaps and other derivatives is that other types of risks, namely market risk, play a more significant role in asset valuation than credit risk. The Basle Committee grappled with the complications of derivatives in banking activities for a few years after the Accord and issued capital adequacy guidelines on the treatment of such activities.¹⁹⁷ The Committee even allowed individual banks to deter-

¹⁹² Bruce S. Darringer, *Swaps, Banks, and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basle Accord's Treatment of Swaps*, 16 U. PA. J. INT'L BUS. L. 259, 260 (1995); see also Lee, *supra* note 37, at 15 ("Banks are also increasingly using new financial instruments to diversify their earnings, enhance their profits, and hedge potential risk.").

¹⁹³ Darringer, *supra* note 192, at 265; see also SCOTT & WELLONS, *supra* note 8, at 1236 (defining derivatives in the glossary as "[f]inancial instruments whose value is based on that of another security or its underlying asset"). Derivatives are very important instruments because they allow parties with different risk rates and preferences to hedge against changes brought about by the market. See Darringer, *supra* note 192, at 265 ("Derivatives are extremely important because they facilitate the ability to transfer and accept risks, enabling entities to hedge against fluctuations in profits which may be caused by changes in exchange rates, interest rates, commodity prices, or equity prices.").

¹⁹⁴ See Darringer, *supra* note 192, at 265.

¹⁹⁵ S. Henderson, *Swap Credit Risk: A Multi-Perspective Analysis*, in INTERNATIONAL BANKING AND CORPORATE FINANCIAL OPERATIONS 41 (K. Lian et al. eds., 1989); see also Darringer, *supra* note 192, at 266 ("A swap is a contract whereby two counterparties agree to exchange future cash flows at periodic intervals during the life of the swap according to a prearranged formula.").

¹⁹⁶ See *Basle Accord*, *supra* note 7, annex 3, at 24 (discussing the treatment of "foreign exchange and interest rate related items," including swaps, as off-balance-sheet assets).

¹⁹⁷ See Amendment to the Capital Accord to Incorporate Market Risks, Jan., 1996, at 1-8 (amending the 1988 Accord to include capital cushions for market risk, brought mainly by derivatives activities); see also Matthews, *supra* note 79, at 167-70 (discussing the treatment of derivative holdings by banks under the current Basle Accord). The

mine market and other risks associated with derivatives by using internal credit risk models.¹⁹⁸ Thus, the Committee's large degree of deference to commercial banks clearly evidences the shortcomings of the Accord's ability to cope with financial products that are now a larger portion of the business of banking. Moreover, as one commentator has noted, "[m]any current securitization structures were not contemplated when the Accord was drafted, and cannot be addressed effectively within the current [Basle] framework."¹⁹⁹

In summary, the Basle Accord, originally a divine miracle of legal process, has become a problem child of regulatory conformity. The Basle Accord commits seven deadly sins, all of which detract from the twin goals of establishing accurate cushions against bank credit risks and leveling the playing field among participating nations. The Accord's seven problems—its inaccurate, micromanaging of bank risks categorically; its failure to finally establish a comprehensive definition of regulatory capital; its desultory adoption of the 8% capital ratio; its presumption that equity serves as an inherently better cushion than debt; its presumption that capital standards alone could level the international playing field; its ignorance of risk reduction engendered by diversification; and its inability to effectively regulate complex financial instruments and transactions that are becoming more prevalent in banking—have made the materialization of the Committee's aspirations all the more impossible. The Committee's failure to provide capital adequacy standards that ensure a stable and efficient international banking system results from its violation of a cardinal economic principle: "The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."²⁰⁰ The Basle Committee, in its effort to hastily manufacture a set of capital adequacy rules, failed to contemplate both the short- and long-term results of applying such rigid rules.

fifth flaw of the Accord, its ignorance to diversification, has combined with this last flaw to increase the inaccuracy of derivative risk calculations. "Basle fails to take account of whether a bank's swap portfolio is diversified across various counterparties and industries." Darringer, *supra* note 192, at 311-12.

¹⁹⁸ See Darringer, *supra* note 192, at 301-11 (discussing the Committee's approval of banks determining credit risk through models).

¹⁹⁹ Jones & Mingo, *supra* note 155, at 59.

²⁰⁰ HENRY HAZLITT, *ECONOMICS IN ONE LESSON* 17 (3d ed. 1979) (emphasis omitted).

IV. THE 1999 BASLE COMMITTEE PROPOSAL

By 1999, more than one hundred nations had implemented the capital adequacy standards designed by the Basle Committee.²⁰¹ Since the Accord is wrought with flaws, countries around the world have felt the ill effects of their newly adopted capital standards. After more than a decade of inaccurate capital ratios leading to regulatory arbitrage and the international credit crunch, regulatory bodies and bankers from nearly all participating nations lost their tolerance for the 1988 Accord and petitioned for change.

Their petition forced the Basle Committee to acknowledge the weaknesses of the original Accord and subsequent Concordats.²⁰² The Committee admitted that the "current risk weighting of assets results, at best, in a crude measure of economic risk," which has enabled "banks to arbitrage their regulatory capital requirement and exploit divergences between true economic risk and risk measured under the Accord."²⁰³ In June 1999, the Basle Committee issued *A New Capital Adequacy Framework*, a major consultative paper, which will serve as the basis for a new Basle Capital Accord in late 2000 or 2001.

The Basle Committee stated four objectives of the new Accord: (1) improving "safety and soundness in the financial system," (2) promoting "competitive equality," (3) establishing "a more comprehensive approach to addressing risks," and (4) making the requirements "suitable for application to banks of varying levels of complexity and sophistication."²⁰⁴ To achieve these goals, the Committee divided its proposed reforms into "three pillars: *minimum capital requirements*; a *supervisory review* of capital adequacy; and *market discipline*."²⁰⁵ To some degree, these three pillars of regulatory reform will partially eliminate some of the problems of the 1988 Accord by improving the accuracy of the risk weights and encouraging banks to improve their own internal standards for allocating capital against risk. The *New Framework*, however, is not without its own flaws. Unfortunately, the proposal retains some of the defects of the original Accord and even introduces some new problems as well. An outline of the new proposal follows.

²⁰¹ See *New Framework*, *supra* note 10, ¶ 44 ("Over 100 countries have adopted the Accord . . .").

²⁰² See *id.* ¶¶ 4-8 (describing some of the weaknesses of the Accord).

²⁰³ *Id.* ¶¶ 6-7.

²⁰⁴ *Id.*

²⁰⁵ *Id.* ¶ 2 (emphasis added).

A. *Minimum Capital Requirements*

The Committee has again decided to set minimum capital requirements for all commercial banks that will serve as a baseline capital buffer against losses realized from the actualization of credit and accompanying risks. In doing so, the Committee will maintain the original definition of regulatory capital "as set out in the 1988 Accord."²⁰⁶ Each bank will still be required to maintain 8% of its qualifying regulatory capital against its total of risk-weighted assets. Therefore, the rudimentary equation establishing minimum capital requirements will remain the same under this proposal.²⁰⁷ "A bank's risk-based capital ratio will continue to be calculated by dividing its qualifying capital (the numerator of the ratio) by its weighted-risk assets (the denominator)."²⁰⁸ All banks would continue to evaluate how much of their capital qualifies as Tier 1 and Tier 2 holdings, not allowing the entire dollar amount of Tier 2 to exceed that of Tier 1.²⁰⁹ Consequently, the calculation of the denominator, not the numerator of the capital ratio, will change if the proposal is adopted as the new Accord.

In determining the amount of risk-weighted assets to which at least 8% of a bank's capital will be apportioned, the Basle Committee has decided to eliminate most of the rigid categorical structure of the 1988 Accord in favor of a more dynamic and accurate assessment of each asset's risk.²¹⁰ Weights will continue to be expressed in the whole percentages of 0%, 20%, 50%, and 100%.²¹¹ The most risky assets would be assessed as having a risk weight of 150%.²¹² In determining which assets fall into the various risk categories, the Basle Committee no longer deems certain loans as falling unequivocally within a certain risk weight. A bank's claim on an unsecured corporate loan would

²⁰⁶ *Id.* ¶ 20; see also *id.* annex 2, ¶ 1 ("The Committee does not propose at this stage to make further amendments to the definition of capital.").

²⁰⁷ See *supra* text accompanying note 109 (discussing the required capital ratio banks must maintain under the terms of the Basle Accord).

²⁰⁸ 12 C.F.R. § 208 app. A (1999).

²⁰⁹ See *id.* attachment II (discussing the limitations on Tiers 1 and 2 of qualifying regulatory capital).

²¹⁰ See *New Framework*, *supra* note 10, ¶ 23 (discussing how "the Committee is proposing revisions to the existing approach to credit risk" in the new proposal).

²¹¹ See *id.* annex 2, ¶ 6 (explaining what the various risk-weights signify).

²¹² See *id.* ("Claims on countries rated below B- would be weighted at 150%."); see also *id.* annex 2, ¶ 23 (describing why the Committee is proposing to add higher risk categories for specific assets with a "relatively adverse default history and high price volatility").

not automatically require a 100% risk weighting, as it presently does. To rate the risks involved with various assets, the Basle Committee may permit two distinct approaches: the Standardised Approach and the Internal Ratings-Based Approach.²¹³

1. The Standardised Approach

The Standardised Approach will be used "for calculating capital charges at the majority of banks."²¹⁴ Some sophisticated banks have developed internal rating systems to rate the quality of their largest borrowers.²¹⁵ From these internal ratings, banks can more accurately assess the risk involved in loans to such borrowers. Since most banks, however, do not rely on internal ratings, they must rely on either a regulatory benchmark or an outside party to assess the risk of each loan. Currently, these banks simply determine into which risk-weight category the asset falls and then multiply the asset by the percentage predetermined by the Basle Committee. Instead of the predefined risk categories of the 1988 Accord, the Committee has proposed the "use of external credit assessments," most commonly in the form of rating agencies.²¹⁶ Thus, rating agencies such as Standard & Poor's would rate the borrower's financial stability and ability to satisfy its obligations. The commercial bank could then use this rating to benchmark the risk of the loan made to that entity and then convert it to a risk percentage.²¹⁷

To explain the difference between the new proposal and the current Accord, it is helpful to use a hypothetical. Suppose Bank A lent the Microsoft Corporation \$1,000,000,000 (without taking a security interest in collateral) to be repaid in ten years. Under the current capital adequacy rules, the risk weight of the loan would be assessed at 100%,²¹⁸ meaning that a full \$80,000,000 in qualifying regulatory capi-

²¹³ See *id.* ¶¶ 23, 25 (providing summaries of the standardised approach and the internal ratings-based approach).

²¹⁴ *Id.* ¶ 23.

²¹⁵ See *infra* text accompanying notes 245-47 (describing the alternative internal ratings-based approach, which allows certain banks to be exempted from relying on external credit agencies if they maintain an internal system for assessing the financial risks of borrowers).

²¹⁶ *New Framework*, *supra* note 10, ¶ 23.

²¹⁷ See *id.* annex 2, ¶ 18 (explaining the new, proposed weighting methodology).

²¹⁸ See 12 C.F.R. § 208 app. A, attachment III (1999) (requiring that "[a]ll other claims by private obligors" including commercial loans, be assessed at 100%); Stewart, *supra* note 147 ("At present, if an AA-rated corporate and another rated BBB have ten-year facilities with a given bank, they both require the same capital usage.").

tal would be required as a cushion against the loan's risk of default.²¹⁹ Under the new proposal, the end result may be different depending on the rating of Microsoft as assessed by an external credit rating agency. If Standard & Poor's rates Microsoft as "AAA,"²²⁰ the company's highest quality rating, then the new proposal would provide for a corresponding risk weight of 20%. The amount of qualifying capital required to serve as a cushion against the loan would only be \$16,000,000.²²¹ Therefore, the new proposal would taper Bank A's capital requirement by \$64 million for the same \$1,000,000,000 loan to Microsoft. If the rating agencies' assessments are accurate, the new proposal will lead to a more precise weighing of risk and a decrease in regulatory arbitrage. Moreover, implementation of the *New Framework* could provide opportunities for the most solvent companies to borrow at lower interest rates since up to 80% of the risk-weights may be reduced on their loans.

For claims against central governments (sovereigns), the Basle Committee has proposed abandoning the current rule that allocates no risk to loans made to OECD central governments. Instead, the Committee would allow the ratings of external agencies to correspond to a sliding scale of risk weights ranging from 0% to 150%.²²² Thus, if the U.S. government were rated as a AAA borrower by Standard & Poor's or another external rating agency,²²³ a long-term treasury bond would receive a risk-weighting of zero, thus requiring no capital cushion. On the other hand, if a commercial bank had a loan outstanding

²¹⁹ The \$80 million capital requirement derives from multiplying the value of the Microsoft loan by its corresponding risk weight and the required capital ratio of the Accord. Thus, $\$80,000,000 = \$1,000,000,000 \times 100\% \times 8\%$.

²²⁰ See *New Framework*, *supra* note 10, annex 2, ¶ 5 (discussing the various risk weights that correspond to the external credit ratings of private rating agencies).

²²¹ $\$16,000,000 = \$1,000,000,000 \times 20\% \times 8\%$.

²²² See *New Framework*, *supra* note 10, annex 2, ¶ 4 (discussing the application of different risk weights corresponding to the "assessment results of eligible external credit assessment institutions").

²²³ Although rating agencies differ somewhat in their designations of good and bad ratings, the ratings used by the most popular agencies are similar:

Credit Assessment Institution	Very High Quality Assessment	Very Low Quality Assessment
Fitch IBCA	AA- and above	Below B-
Moody's	Aa3 and above	Below B3
Standard & Poor's	AA- and above	Below B-
Export insurance agencies	1	7

Id. annex 2, ¶ 32, Table 2 (footnotes omitted).

to a country rated at the very bottom of the scale (e.g., Haiti, rated below B-), the dollar amount of the loan would be assessed at 150%. The effect of this rating would be the bank holding twelve cents of qualified regulatory capital for every dollar of the loan.²²⁴ The proposal to change the current flat zero risk rate for OECD countries was a direct response to problems that arose when banks began loaning excessive amounts to countries whose repayment ability was questionable.²²⁵ The Committee admitted that the current standards are inaccurate since "some countries that [did] not merit inclusion on grounds strictly related to default risk would be included in the preferential group, while potentially high credit quality countries outside the OECD [were] excluded."²²⁶

The Committee also proposes using the ratings of external agencies to assess the risk of long-term claims on banks.²²⁷ In obtaining the credit risk percentage for each bank, the Committee proposes two options. The first is "revis[ing] the Accord so that claims on banks would be given risk weights based on the weighting applied to claims on the sovereign in which the bank is incorporated."²²⁸ Since private banks normally are not as solvent as central governments, the bank would receive the next highest risk weight attributable to its government.²²⁹ For instance, if Canada as a sovereign received a 0% credit risk weight from an external rating agency, an unrated Canadian commercial bank would receive a 20% risk rating.

The second option proposed by the Committee provides for the risk weighting of bank debt on the basis of the individual bank's assessment by a rating agency.²³⁰ This option would compensate financially strong banks based in weak nations. Under this scheme, a par-

²²⁴ If the risk rate is 100%, a full 8% of qualified regulatory capital must serve as a cushion. This requirement means that the bank must set aside eight cents of capital for every dollar loaned. If the risk rate is 150%, the bank must hold 1.5 times the capital ratio. In effect, this changes the required capital ratio for the full dollar amount of the asset to 12%. Thus, for every dollar of the claim assessed at 150%, the bank must set aside a corresponding 12 cents of regulatory capital.

²²⁵ See *supra* text accompanying note 166 (discussing the financial conundrum of allocating zero risk to Mexico, which had recently joined the OECD).

²²⁶ See *New Framework*, *supra* note 10, annex 2, ¶ 3.

²²⁷ See *id.* annex 2, ¶¶ 11-12 (discussing the current proposal's treatment of "[c]laims on banks").

²²⁸ *Id.* annex 2, ¶ 11.

²²⁹ See *id.* ("The weight applied to the bank would be one category less favourable than that applied to the country.").

²³⁰ See *id.* annex 2, ¶ 12 ("The second option would be to use ratings assigned directly to banks by an external credit assessment institution.").

ticularly strong bank could receive the same weight as its central government, provided that weight was not 0%. Again, a bank could not be assigned a risk weight that was lower than its national government and no bank debt could receive a risk weight of less than 20%.²³¹ The Committee also proposes that claims on securities firms "should generally be weighted in the same way as claims on banks."²³²

In addition, the Committee proposes that claims on corporations be subject to the assessment of external rating agencies. The proposed degree of diversity in corporate ratings is, however, severely limited. The Committee suggests the assignment of a lower risk percentage than the current mandatory weight of 100% for only the highest caliber corporations, as designated by external rating agencies.²³³ The proposal would also allow a risk weighting of 150% for claims on the poorest rated corporations.²³⁴ Claims on corporate loans are also subject to the general rule that disallows the assignment of "a risk weight preferential to the risk weighting assigned to a claim on the sovereign of the corporat[ion]'s country of incorporation."²³⁵

The effect of these somewhat confusing rules is the establishment of three possible risk weights for corporate claims. First, the lowest quality claims will receive a 150% risk weight. Second, the claims on the highest rated corporations (i.e., AAA) will receive a 20% risk weight. Third, the Committee proposes to assign every other corporate claim a 100% risk weight, whether it is rated above or below average. The Committee's proposal will thus preserve the status quo, since a majority of these claims will be weighted at 100%, the same percentage assigned under the current regime.

²³¹ See *id.*

²³² *Id.* annex 2, ¶ 16.

²³³ See *id.* annex 2, ¶ 18 (proposing to allow only "claims on corporates of a very high quality" to be afforded a lower risk weight).

²³⁴ See *id.* (noting "that a weighting of 150% [should] be given to claims on corporates which are of very low quality").

²³⁵ *Id.*

SUMMARY OF THE STANDARDISED APPROACH²³⁶

Claim		Assessment					
		AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereigns		0%	20%	50%	100%	150%	100%
Banks	Option 1 ¹	20%	50%	100%	100%	150%	100%
	Option 2 ²	20%	50% ³	50% ³	100% ³	150%	50% ³
Corporates		20%	100%	100%	100%	150%	100%

¹ Risk weighting based on risk weighting of the sovereign in which the bank is incorporated.

² Risk weighting based on the assessment of the individual bank.

³ Claims on banks of a short original maturity, for example less than six months, would receive a weighting that is one category more favourable than the usual risk weight on the bank's claims.

The Basle Committee intends to retain the other risk weights established by the current regime. Mortgages for residential properties will continue to receive a 50% risk weight.²³⁷ The credit conversion factors currently in force for off-balance sheet items²³⁸ will also remain in place if the *New Framework* replaces the 1988 Accord.²³⁹ In its description of the standardised approach, the Committee acknowledged that maturity of the claims is also a relevant factor in determining the asset's credit risk.²⁴⁰ However, "the Committee at present is not pro-

²³⁶ See *id.* annex 2, ¶ 20, tbl. 1.

²³⁷ See *id.* annex 2, ¶ 21 (stating that "lending fully secured by mortgages on residential property . . . should continue to be weighted at 50%").

²³⁸ See 12 C.F.R. pt. 208 app. A, attachment IV (1999) (delineating the credit conversion factors currently in force in the United States).

²³⁹ See *New Framework*, *supra* note 10, annex 2, ¶ 25 ("The Committee is not proposing to change the existing conversion factors for off-balance-sheet items . . ."). Commitments, which will not remain the same if the new proposal is adopted, comprise the one small exception. "Given that even short-term commitments entail some risk, the Committee is proposing a credit conversion factor of 20%, which would principally apply to business commitments." *Id.* annex 2, ¶ 26.

²⁴⁰ See *id.* annex 2, ¶ 28 (acknowledging that when "the credit quality of two borrowers is equivalent, the exposure to the borrower with the longer-term claim would generally be riskier than that to the borrower with the shorter-term claim").

posing to take maturity of claims into account for capital purposes.²⁴¹ For those assets whose risk weights would be altered by external credit ratings, the Committee suggested that bank regulators examine the following factors in assessing whether a credit rating agency can properly rate entities: (1) objectivity, (2) independence, (3) transparency, (4) credibility, (5) international access, (6) resources, and (7) recognition.²⁴² In addition to requiring national regulators to approve a bank's use of individual ratings, the Committee would require banks "to disclose the credit assessment institutions that they use for the risk weighting of their assets, including the percentage of their assets' risk weightings based on assessments by each such institution."²⁴³ This requirement will ensure that banks will not use sub-par rating agencies with differing appraisals to commit credit-rating arbitrage.²⁴⁴

2. The Internal Ratings-Based Approach

Although most banks would use the standardised approach if the *New Framework* is adopted, some banks would use the internal ratings-based approach. This approach is reserved for "sophisticated banks" that already use internal systems for evaluating "the risk of individual credit exposures."²⁴⁵ Banks that possess an internal process of assessing the economic risks of borrowers would therefore be exempted from relying on external credit agencies. Before receiving such an exemption from the standardised approach, individual banks would need to obtain approval from regulatory authorities.²⁴⁶ The Committee concedes that the possibility of increased popularity of the internal ratings-based approach could push the now nearly uniform capital

²⁴¹ *Id.*

²⁴² *See id.* annex 2, ¶ 29 (listing the minimum criteria suggested by the Committee).

²⁴³ *Id.* annex 2, ¶ 32.

²⁴⁴ External credit assessments can result in credit-rating arbitrage as well. For example, if Standard and Poor's were to rate a corporate claim as the very highest quality, the corresponding risk weight under the proposal would be 20%. If other external agencies, such as Moody's and Fitch IBCA, were to rate the corporate claim at anything lower than the very highest appraisal, the corresponding risk weight under the proposal would be 100%. Therefore, the bank would clearly have an incentive to choose the S & P rating since it requires 80% less regulatory capital per dollar of the claim. The Committee wants to prevent this form of regulatory arbitrage. "Banks must adopt a consistent approach in using a particular assessment mechanism and should not 'cherry pick' among assessments." *Id.* annex 2, ¶ 2.

²⁴⁵ *Id.* annex 2, ¶ 42.

²⁴⁶ *See id.* annex 2, ¶ 46 (stating that "prior supervisory approval would be necessary before banks could be allowed to use their internal ratings systems for setting minimum capital requirements").

adequacy regime back to square one. "The lack of homogeneity among the rating systems at different banks, together with the central role of subjective risk factors and business judgments in assigning internal grades, means that comparability across institutions and countries presents an important hurdle."²⁴⁷ Nevertheless, the internal ratings-based approach has its virtues.

The Basle Committee has stated that its "longer-term aim is to develop a flexible framework that reflects more accurately the risks to which banks are exposed."²⁴⁸ The current risk-based categories are only rough approximations of risk and are highly inflexible. The standardised approach increases the accuracy and flexibility of the assignment of risk weights through the use of external rating agencies. Therefore, the next logical step toward accuracy and flexibility is the internal ratings-based approach. By allowing each bank to weigh the risks of its assets by using the same internal methods that are already commonly used for "loan approval requirements" and "analysis of pricing and profitability," this approach fulfills the Committee's flexibility objective.²⁴⁹

The internal ratings-based approach also may improve the accuracy of risk weights. First, because the bank deals directly with customers whose claims it will rate, the rating "may incorporate supplementary customer information which is usually out of the reach of an external credit assessment institution, such as detailed monitoring of the customers' accounts and greater knowledge of any guarantees or collateral."²⁵⁰ Greater availability of borrower information facilitates more precise ratings by an objective party. Since the lender usually has more data on the borrower than a third party, it follows that the lender will be in a better position to render an accurate rating.

Second, the standardised approach only varies the degree to which sovereigns, large banks, and corporations are weighted. The assessment of smaller borrowers may fall outside of the profitable ambit of external rating agencies. If this occurs, claims on those borrowers would receive the default risk weightings of the current Basle Accord. Unrated corporate borrowers, no matter how solvent, would receive a 100% risk weight.²⁵¹ Banks using internal systems usually rate

²⁴⁷ *Id.* annex 2, ¶ 45.

²⁴⁸ *Id.* ¶ 12.

²⁴⁹ *Id.* annex 2, ¶ 42.

²⁵⁰ *Id.* annex 2, ¶ 43.

²⁵¹ See SUMMARY OF THE STANDARDISED APPROACH, *supra* text accompanying notes 236-44 (discussing risk weighting in the standardised approach).

all borrowers in some manner. Thus, where external agencies fail to rate, internal systems often furnish "assessments of the credit quality of individuals and small-to-medium sized companies through credit scoring, and assessment of larger non-rated borrowers through detailed analysis."²⁵² In terms of assigning risk weights to the bank's internal ratings, the Basle Committee will decide either to link "internal rating categories to the standardised risk weights" or to "design a capital charge which explicitly reflects internal ratings."²⁵³ No matter how the final details are settled, the Committee feels that the internal ratings-based approach will become the standard for ensuring accuracy and flexibility in the risk weighting of claims.²⁵⁴

3. The Road Ahead: Credit Risk Models

Credit risk models are internal systems currently used by sophisticated banks to determine their actual capital requirements. These models are "designed to predict the probability of default and the likely recovery of assets after a default."²⁵⁵ If banks voluntarily maintain more capital than the minimum Basle standard, it is most likely because their internal credit risk models have guided the decision. Unlike internal ratings, which simply assess the credit worthiness of a specific borrower, credit risk modeling supplants the entire regulatory capital adequacy process by: (1) determining an individual bank's target default risk, (2) estimating the risk of its entire portfolio and activities for a specific period, and (3) allocating sufficient capital to ensure a cushion up to the target default risk.

In completing step one, "the target insolvency rate is usually chosen to be consistent with the bank's desired credit rating."²⁵⁶ When a bank determines the total risk of its assets and OBS items, its mathematical model produces a "probability density function (PDF) for credit losses."²⁵⁷ These two variables, the target default risk and the

²⁵² *New Framework*, *supra* note 10, annex 2, ¶ 43.

²⁵³ *Id.* annex 2, ¶ 39.

²⁵⁴ See *id.* annex 2, ¶ 45 ("[I]nternal ratings . . . would represent a major step forward for supervisors from the proposed standardised approach.").

²⁵⁵ SCOTT & WELLONS, *supra* note 8, at 245.

²⁵⁶ Jones & Mingo, *supra* note 155, at 54.

²⁵⁷ *Id.* "When estimating the PDF for credit losses, banks generally employ what we term either 'top-down' or 'bottom-up' methods." *Id.* The "top-down" method relies on "the volatility of charge-offs historically for the type of loan rather than for individual loans." SCOTT & WELLONS, *supra* note 8, at 246. Thus, for small loans to individuals and entities, the top-down approach is likely to be the most efficient. The "bottom-up" method involves the assessment of each asset credit risk "based on an explicit

comprehensive asset risk, are then evaluated by "a consistent 'capital allocation rule' . . . to determine the amount of capital that should be held internally."²⁵⁸ Therefore, an individual bank's determination of its own capital needs is simply that amount of capital exceeding projected losses at the target insolvency level.²⁵⁹ This internal process of determining capital adequacy could eventually supersede the entire structure of the current regulatory regime.

Although the Basle Committee specifically stated that it will retain both the current definition of regulatory capital and the 8% ratio for the next Accord,²⁶⁰ it has noted explicitly that credit risk models may be looming on the road ahead. The Committee acknowledged that "credit risk modelling may prove to result in better internal risk management, and may have the potential to be used in the supervision of banks."²⁶¹ As banks move from the standardised approach to the internal-ratings based approach (assuming the proposal is adopted), they become less dependent on the Committee's guidelines for weighing the risks of assets. The next logical phase is for banks to allocate their own internally-generated target amount of capital, rather than rely on the Basle Committee's rigid capital ratio. Credit risk modeling is conceivably the final step toward the Committee's "longer-term aim" of providing flexibility and accuracy to the process of ensuring that bank capital adequately guards against economic risk.²⁶² The Committee "intends to monitor developments in this area closely, and hopes to engage the industry in a constructive dialogue."²⁶³

B. Supervisory Review of Capital Adequacy

The second pillar of the *New Framework* is increasing regulatory supervision of banks in their implementation of the first pillar, minimal capital standards. The Committee states that regulatory authorities have the twin goals of ensuring "that the [bank's capital] position is consistent with its overall risk profile and strategy" and intervening

credit evaluation of the underlying customer." Jones & Mingo, *supra* note 155, at 55.

²⁵⁸ Mingo, *supra* note 34, at 50.

²⁵⁹ See Jones & Mingo, *supra* note 155, at 54 (explaining that "required economic capital is the amount of equity over and above expected losses necessary to achieve the target insolvency rate").

²⁶⁰ See *New Framework*, *supra* note 10, ¶ 20; see also *id.* annex 2, ¶ 1 ("The Committee does not propose at this stage to make further amendments to the definition of capital.").

²⁶¹ *Id.* annex 2, ¶ 52.

²⁶² *Id.* ¶ 12.

²⁶³ *Id.* annex 2, ¶ 53.

promptly "if the capital does not provide a sufficient buffer against risk."²⁶⁴ To achieve these twin aims, the Basle Committee is urging national bank regulators to increase both manpower and financial acumen.²⁶⁵ The proposal also encourages regulators to go beyond the simple audit of ledgers and to examine each bank's fundamental strategy in assessing its required capital. Regulators are called upon to evaluate such factors as the "bank's risk appetite," the "markets in which the bank operates," and the "diversification of its activities."²⁶⁶ Finally, the Committee mandates that regulatory agencies coordinate their activities when assessing banks operating across national borders.²⁶⁷

C. *Market Discipline*

The third pillar of the 1999 proposal is market discipline. The Committee wants market participants to reward or punish banks for high capital standards, or a lack thereof, instead of having banks answer solely to regulatory authorities for maintaining adequate capital standards. After all, a "bank that is perceived as safe and well-managed in the marketplace is likely to obtain more favourable terms and conditions in its relations with investors, creditors, depositors and other counterparties than a bank that is perceived as more risky."²⁶⁸ Enhanced public perception will stem from increased disclosure requirements for banks. The *New Framework* requires banks, swiftly and openly, to "disclose all key features of the capital held as a cushion against losses, and the risk exposures that may give rise to such losses."²⁶⁹ Although increased disclosure certainly will provide some incentives for banks to maintain adequate capital, the Committee

²⁶⁴ *Id.* ¶ 32.

²⁶⁵ *See id.* ¶ 36 (encouraging regulatory agencies to examine closely "the number and skill level of supervisory staff required to carry out this work").

²⁶⁶ *Id.* ¶ 34.

²⁶⁷ *See id.* ¶ 36 (requiring "bank supervisors to work in close co-operation to evaluate the risk profile of internationally active banks and to ensure consistency of standards across national borders").

²⁶⁸ *Id.* ¶ 39.

²⁶⁹ *Id.* ¶ 41. "This information should, at a minimum, be provided in annual financial reports and should include quantitative and qualitative details on the bank's financial condition and performance, business activities, risk profile, and risk management activities." *Id.*; *see also* Basle Comm. on Banking Supervision, *Enhancing Bank Transparency* (Sept. 1998) <<http://www.bis.org/publ/index.htm>> (discussing ways to optimize disclosure to ensure banking supervision and market discipline).

concedes that the disciplining effect of the market will dissipate in countries with comprehensive deposit insurance regimes.²⁷⁰

D. *The Basle Committee's Superficial Act of Contrition*

During the last decade, many bankers, lawyers and regulators have waited with great hope for a second comprehensive meeting of the Basle Committee. They hoped that the Committee would atone for the sins it committed in the 1988 Accord by eliminating many of the defects of the current regulations.²⁷¹ The issuance of the *New Framework* is evidence that the Basle Committee's vowed rectification of the flaws of the earlier Accord is more superficial than substantive. The proposal addresses only one or two of the 1988 Accord's seven deadly sins. Even with those addressed, the proposal's ameliorative effect will be limited. There is also the possibility that the new proposal could present even more dilemmas because of its reliance on external rating agencies and its plan to move eventually toward internal credit risk models.

The first and most serious flaw of the 1988 Accord is its inaccurate categorization of risks by asset type.²⁷² The new proposal seeks to improve the accuracy of risk weights in both the standardised and internal ratings-based approaches. The current proposal retains the four rigid categories of risk weights (0%, 20%, 50%, and 100%) and even adds a new one (150%).²⁷³ No matter what the perceived risk of default for an individual asset, the risk weight assigned must be one of the five aforementioned percentages, and not, for example, 35% or 75%, even if such percentages are more precise measures of risk.²⁷⁴ As for the link between the fixed risk weights and the type of assets, the Committee eliminates classification by category by allowing external

²⁷⁰ See *New Framework*, *supra* note 10, ¶ 40 (admitting that "a bank may not be subject to market discipline from a fully insured depositor who has nothing at risk, and therefore no motive to impose discipline").

²⁷¹ See *Statement No. 160*, *supra* note 11 (discussing the universal "sense of urgency for [the Basle Committee to reform its] international capital standards").

²⁷² See *supra* text accompanying notes 145-66 (discussing the first "sin" of the Accord).

²⁷³ See *supra* table accompanying note 236 (discussing the various risk weights and their retention as whole percentages); *supra* text accompanying notes 211-12 (same).

²⁷⁴ This is certainly true for the majority of regulated banks, which will follow the standardised approach. For the internal ratings-based approach, the Basle Committee has not yet made a definitive determination of the risk weights it will institute corresponding to internal ratings. It has suggested, however, that "banks could map their internal rating categories to the standardised risk weights." *New Framework*, *supra* note 10, annex 2, ¶ 39.

rating agencies and internal ratings systems to evaluate assets individually before assigning them a risk weight. For the standardised approach, which will become the governing framework for the majority of banks if the new Accord is established, the Committee has abandoned fixed categories for claims on sovereigns, banks, and corporations by delegating most of the task to external agencies.²⁷⁵ The ratings are then converted to corresponding risk rates. The result is that banks are able to allocate differing amounts of capital to two assets of the same type that pose different degrees of credit risk. For example, if external agencies assign an average or poor rating to Mexico as a sovereign, bond holdings issued by the Mexican central government may not receive an exemption from the regulatory capital requirement, as do claims on the U.S. government.²⁷⁶ Consequently, the incentive to purchase high yielding Mexican debts instead of lower yielding U.S. treasury instruments will decrease. Loan incentives for riskier corporations, as opposed to the most solvent corporations, will also decline under the proposal, because both claims will no longer automatically be assigned a 100% risk weight. Provided that banks are earnest, the internal ratings-based approach will produce the same effect. Thus, the new proposal will abate some degree of "regulatory arbitrage" currently motivated by the 1988 Accord. Many believe the assessment of individual assets through external and internal ratings of borrowers "would provide a more efficient means of maintaining bank safety than imposing imprecise blanket capital requirements."²⁷⁷ Although the proposal appears to make "sweeping changes" to the current regime, the actual modification of risk weights per asset is largely illusory.

The trouble with the new proposal's treatment of risk weights, especially under the standardised approach, is twofold. First, the exter-

²⁷⁵ See *New Framework*, *supra* note 10, annex 2, ¶¶ 2-20 (same); *supra* Part IV.A.1 (discussing the new risk-weighting procedures for sovereigns, banks, and corporates under the standardised approach).

²⁷⁶ Since Mexico and the United States are OECD countries, the Accord currently assigns a 0% risk weight to all claims on them. See *Basle Accord*, *supra* note 7, ¶ 36 (noting that "claims on central governments within the OECD will attract a zero weight"); 12 C.F.R. § 208 app. A, attachment III (1999) (summarizing risk weights). This effectively means that no regulatory capital must be held against these assets. If Mexico is assigned a risk weight higher than zero, claims on the Mexican central government will require a cushion of regulatory capital.

²⁷⁷ Conroy, *supra* note 14, at 2443; see also Jones & Mingo, *supra* note 155, at 59 (stating that "in contrast to the one-size-fits-all Basle standard, a bank's internal capital allocation against a fully funded, unsecured commercial loan will generally vary with the loan's internal credit rating").

nal rating agencies can only affect the risk weights of claims of sovereigns, banks, and corporations.²⁷⁸ Even the effect of external ratings on these claims is severely limited. One limitation is that banks and corporations are capped at a 20% risk rate.²⁷⁹ Another limitation is that these private entities are prohibited from acquiring a lower risk weight than the central governments of their respective home countries.²⁸⁰ Moreover, the risk weight on claims on some banks would be directly linked to the risk weights of their sovereigns. Less precise risk weights result because "not all institutions in a given country present equal risk. You can have a good bank in a bad country and a bad bank in a good country"²⁸¹ Less precision in risk weights will inevitably lead to capital-requirement arbitrage. The partitioning of claims on corporations into what seems to be "haves" and "have-nots" is also a particularly disturbing limitation. Only corporations receiving the very highest rating will be eligible for the 20% risk weight, while banks must assign all others at least a 100% risk weight.²⁸² Thus, a corporation with an A+ rating from Standard and Poor's would receive the same risk weight as a corporation with a B- rating.²⁸³ Again, the incentive for regulatory arbitrage is present. Since most corporations would receive the same 100% risk weight as they did under the 1988 Accord, the prospects for preventing another international credit crunch are poor.

The other major problem with the proposal's treatment of risk weighting is that the current risk weights are likely to remain the

²⁷⁸ See *supra* table accompanying note 236 (summarizing the standardised approach).

²⁷⁹ See *New Framework*, *supra* note 10, annex 2, ¶¶ 12, 18 (discussing the lowest risk weights that banks and corporations are eligible to receive). The Shadow Committee surmises that "[t]he disparity presumably reflects an attempt to enlist support for the proposed system from countries where most firms are not rated but is unlikely to represent the true credit quality of many unrated borrowers." *Statement No. 160*, *supra* note 11.

²⁸⁰ See *New Framework*, *supra* note 10, annex 2, ¶ 12 ("[N]o claim on a bank could receive a risk weight less than that applied to claims on its sovereign."); *id.* annex 2, ¶ 13 ("No claim on a corporate could be given a risk weight preferential to the risk weighting assigned to a claim on the sovereign of the corporate's country of incorporation.").

²⁸¹ *Basle Capital Accord: The First Revision Is Out*, INT'L BANKER, June 7, 1999, available in 1999 WL 5992124.

²⁸² See *New Framework*, *supra* note 10, annex 2, ¶ 18 ("The Committee now proposes that the standard weighting of claims on corporates remains at 100%, but that a weighting of 20% be given to claims on corporates of a very high quality . . .").

²⁸³ See *id.* (stating that all loans to corporations below "a minimum rating of AA-" would be adjudged at least a 100% risk weighting).

norm under much of the standardised approach, despite the ratings of external agencies. Many borrowers fall outside of the ambit of credit rating agencies. For example, it may be inefficient for agencies immediately to commit resources to rate small banks and corporations. Rating agencies are most prevalent in the domestic markets of the United States and the United Kingdom, which leaves unrated many non-American and non-British corporations.²⁸⁴ These entities would be assigned the 100% rate for unrated corporations,²⁸⁵ which is the same rate the current regime assigns to claims on corporations. The assessment of other instruments not usually rated by external agencies, such as short-term, asset-backed investment vehicles, will continue under the blanket categories currently in force.²⁸⁶ Virtually everything else will be weighted under the 1988 Accord standards. For instance, there will be no change to the 50% risk weight imputed on mortgages for residential properties.²⁸⁷ Credit conversion factors for off-balance sheet items currently in force will essentially remain unmodified.²⁸⁸ Since many assets will receive the same blanket risk weight under the proposal as they do under the current Accord, the Committee's revision of the risk-weighting process falls short of expunging all incentives for arbitrage.

The second major flaw of the Basle Capital Accord is its failure to provide a comprehensive definition of regulatory capital.²⁸⁹ The Basle Committee remains unrepentant for this omission, stating that it "does not propose at this stage to make further amendments to the definition of capital."²⁹⁰ As a result, countries will continue to employ

²⁸⁴ This topic will be discussed in the evaluation of the proposal's efforts to level the playing field among member nations. See *infra* text accompanying notes 296-98.

²⁸⁵ See *New Framework*, *supra* note 10, annex 2, ¶ 20, tbl. 1 (showing that claims of unrated "corporates" would be assigned a 100% risk weight).

²⁸⁶ See *New Capital Proposal Hits Short-Term ABS*, FINANCIAL MODERNIZATION REP., June 21, 1999, at 1 (discussing how the proposal will not help short-term asset-backed securities since they are not usually assessed by external credit rating agencies).

²⁸⁷ See *New Framework*, *supra* note 10, annex 2, ¶ 21 (stating that "lending fully secured by mortgages on residential property...should continue to be weighted at 50%").

²⁸⁸ See *id.* annex 2, ¶ 25 ("The Committee is not proposing to change the existing conversion factors for off-balance-sheet items..."). There is one small exception, commitments, which will not remain the same if the new proposal is adopted. "Given that even short-term commitments entail some risk, the Committee is proposing a credit conversion factor of 20%, which would principally apply to business commitments." *Id.* ¶ 26.

²⁸⁹ See *supra* text accompanying notes 168-72 (discussing the second "sin" of the Accord).

²⁹⁰ *New Framework*, *supra* note 10, annex 2, ¶ 1.

varying definitions of capital, thus thwarting the Committee's goal of uniformity.

The Committee's neglect of the second flaw evidences its refusal to amend the third major defect of the 1998 Accord, the inflexible and somewhat random adoption of the 8% capital ratio.²⁹¹ Although there is a possibility of varying capital ratios if the Committee were to allow banks to use their own credit risk models, the standardised and internal ratings-based approach both would be subject to the same 8% regulatory capital requirement. As in the original Accord, the Committee again offers no extensive explanation for the ratio. Although some bankers object that the ratio requirement is too high, many economists argue that it is too low: "Historical evidence on bank capital structure, as well as evidence on how banks and other financial institutions today choose capital ratios when they are subject to market discipline, suggests that minimum capital ratios should be higher than those currently in place."²⁹²

In refusing to amend the definition of capital and the required ratio amount, the Committee has essentially failed to address the fourth flaw of the 1988 Accord.²⁹³ The Committee's presumption that equity cushions credit risk better than debt will continue to remain a theoretical underpinning if the proposal becomes the new Accord. Since common shareholders will gain directly from higher yields on riskier assets, they have less incentive than debtholders to ensure that commercial banks are more conservative risk takers.²⁹⁴

The fifth major flaw of the 1988 Accord is the Committee's belief that capital standards alone could level the international playing field.²⁹⁵ Although the Basle Committee has long boasted of its role in leveling the playing field among nations, it "did not attempt to address the numerous tax, accounting, economic and regulatory differences between nations which create inequalities among banks."²⁹⁶ In

²⁹¹ See *supra* text accompanying notes 173-77 (discussing the third "sin" of the Accord).

²⁹² *Improving the Basle Committee's New Capital Adequacy Framework: Joint Statement by a Sub-Group of the Shadow Financial Regulatory Committees of Europe, Japan, and the U.S.* (visited Feb. 8, 2000) <<http://www.aei.org/shdw/shdwbasle.htm>> [hereinafter *Improving the New Framework*].

²⁹³ See *supra* text accompanying notes 178-80 (discussing the fourth "sin" of the Accord).

²⁹⁴ See *infra* Part V.A (discussing the reasons why subordinated debt holdings may be a better form of regulatory capital than common equity).

²⁹⁵ See *supra* text accompanying notes 181-89 (discussing the fifth "sin" of the Accord).

²⁹⁶ Alford, *supra* note 26, at 218.

fact, the Basle Accord has not only failed to level the playing field, but also made the field even more uneven for some nations.²⁹⁷ In the *New Framework*, the Committee finally admitted that uniform capital adequacy standards alone are insufficient to establish a level playing field for global banking.²⁹⁸ The establishment of a level playing field is a laudable goal, for the global synthesis of national markets inevitably leads to greater efficiency and aggregate wealth. Therefore, even if capital adequacy standards alone are not sufficient to bring about this process, regulators should at least avoid creating standards that increase inequities among participating nations. The proposal, regrettably, does just this.

The proposal is likely to increase the capital burden on nations with banking systems less developed than the United States. First, since the internal ratings-based approach is reserved for only the most "sophisticated banks,"²⁹⁹ the majority of the participants in this alternative risk-weighting system are most likely to be the colossal banking giants of the United States (and perhaps the United Kingdom, Germany, and Japan as well). Since the internal ratings-based approach will reduce the minimum capital requirement for eligible banks, banks using the standardised approach will be left with comparably higher capital requirements per asset dollar, effectively sustaining a competitive disadvantage.

Even within the standardised approach, banks based in some countries will profit by the proposal, while others will lose. The reliance on external rating agencies will act as the catalyst behind this divide. Since those corporations and banks that lack a rating will receive a default weighting of 100%, banks that loan to these entities will be at a disadvantage compared to banks that hold claims on highly rated banks and corporations. The most predominant rating agencies (Standard & Poor's, Moody's, and Fitch IBCA) assess almost exclusively banks and corporations from the United States and the most developed European nations. Thus, "while the linkage with ratings by agencies removes the earlier broad-brush treatment of all corporates, it does leave scope for inequity for the mass of corporates still not

²⁹⁷ See *supra* text accompanying notes 181-89 (discussing the failure of the Basle Accord to level the playing field among member nations).

²⁹⁸ The Committee forthrightly admits that "differences in national accounting, tax, legal and banking structures will inevitably create differences between national markets and that the use of banking supervisory rules cannot address all these differences." *New Framework*, *supra* note 10, ¶ 14.

²⁹⁹ *New Framework*, *supra* note 10, Executive Summary, ¶ 7.

rated."³⁰⁰ For third-world nations with many unrated banks and corporations, such as India, the amount of capital required per bank is certain to increase.³⁰¹

Surprisingly, even nations with elaborate financial and banking systems, which do not currently rely on private rating agencies, may suffer. For example, "about 8,000 U.S. companies have individual credit ratings from outside agencies, [and] the same is true for only 30 companies in Germany."³⁰² Some view the 100% default rate for non-rated entities as a regulatory encumbrance selectively placed on certain nations. Rolf Breuer, Chairman of the world's largest bank (Deutsche Bank), has exclaimed: "If a rated company has to be backed by a certain amount of capital and a non-rated company has to carry a 'penalty supplement', then . . . Germany would naturally be well behind in comparison with U.S. standards."³⁰³ Not only does the Basle Committee acknowledge that a capital adequacy regime cannot alone achieve a level playing field, but it disregards that goal completely by proposing a new framework that will further augment regulatory inequality among nations.

The sixth of the Basle Accord's seven deadly sins is its ignorance of risk reduction engendered by diversification.³⁰⁴ Again, the *New Framework* fails to address this flaw. For both the standardised and the internal ratings-based approach, the Committee "rejects measuring required capital based on a bank's entire portfolio, and instead incorrectly maintains the current approach of simply adding up the capital required for individual asset categories."³⁰⁵ Diversification may possibly be included in the process by which adequate bank capital is de-

³⁰⁰ Venkitaramanan, *supra* note 137.

³⁰¹ See *Capital Adequacy: Striving Towards an Optimal Ratio*, BUS. LINE, June 9, 1999, available in 1999 WL 17712223 (stating that in terms of the new proposal, "Indian banks will not score well on any of these counts"); *Framework to Provide for Capital Flexibility*, EUR. BANKER, June 1, 1999, available in 1999 WL 11536387 ("Banks with low credit ratings will also have to face the possibility that the cost of international bank borrowing will increase."); *New Basle Norms To Raise Bank's Capital Needs*, BUS. STANDARD, Aug. 12, 1999, at 3 (stating that the "new Basle Committee norms on capital adequacy would increase the capital requirement of commercial banks in India").

³⁰² *German Banks Say Basle Capital Adequacy Proposals Favour U.S., U.K. Rivals*, AFX, Sept. 29, 1999, available in 1999 WL 25405947.

³⁰³ *Id.* (quoting Deutsche Bank AG chairman Rolf Breuer).

³⁰⁴ See *supra* text accompanying notes 190-91 (discussing the sixth "sin" of the Accord).

³⁰⁵ *Statement No. 156 of the Shadow Financial Regulatory Committee on September 27, 1999, The Basle Committee's New Capital Adequacy Framework* (visited Nov. 22, 1999) <<http://www.aei.org/shdw/shdw156.htm>> [hereinafter *The Basle Committee's New Capital Adequacy Framework*].

terminated. This possibility exists with credit-risk modeling since the bank, through internal mathematical analytical tools, assesses the default risk of the entire portfolio. The Committee, however, has made it clear that although credit risk models are on the horizon, individual banks' use of them will not be universally permitted by the next Accord. Therefore, diversification will continue to be excluded from the calculation of total asset risk even if the new proposal is adopted.

The seventh flaw of the Basle Accord is its ineffectiveness in regulating complex financial instruments and transactions that are becoming more prevalent in banking.³⁰⁶ The credit and other economic risks associated with derivatives were not sufficiently addressed by the initial Accord of 1988. Subsequent suggestions for dealing with these atypical but growing banking activities came in the form of additional consultative papers.³⁰⁷ Nonetheless, the original risk-weighted categories and crude capital ratio has remained the mainstay of national regulatory regimes, even with respect to derivatives. Rather than seeking to approximate the genuine risk involved with many off-balance-sheet transactions, the Basle Committee designed its rules "to accommodate the capacities and habits of government regulators who cannot master more analytically complex guidelines."³⁰⁸

Aside from the stream of subsequent suggestions following the Accord, no significant changes in the assessment of derivatives are expected to transpire, even if the new proposal is adopted. The Basle Committee has decided to retain its analytically simplistic treatment of derivatives in lieu of more complex guidelines. Derivative transactions, which do not initially result in alterations of the balance sheet, are currently risk-weighted by credit-conversion factors. The Committee has decided not to amend materially the fixed credit conversion-factors for off-balance-sheet items.³⁰⁹ That many banks have additional subsidiaries and branches operating abroad, which engage in the fa-

³⁰⁶ See *supra* text accompanying notes 192-99 (discussing the seventh "sin" of the Accord).

³⁰⁷ See *supra* note 197 and accompanying text (discussing subsequent amendments to the 1988 Accord that included capital cushions for market risk).

³⁰⁸ James B. Ransom, Note, "Capital Adequacy" in *Crisis: Towards an Optional Bank Deposit Insurance Regime*, 7 S. CAL. INTERDISC. L.J. 445, 453 (1998).

³⁰⁹ See *New Framework*, *supra* note 10, annex 2, ¶ 25 ("The Committee is not proposing to change the existing conversion factors for off-balance-sheet items . . ."); Richard M. Schetman, *Legal Aspects of "Netting" in Respect of Insolvent Derivative Products Counterparties*, in *BROKER-DEALER REGULATION* 87, 137-40 (1999) (explaining how the netting of derivatives would basically remain unchanged under the new Basle proposal).

cilitation of derivative transactions, continues to intensify the problem of ensuring ample capital cushions and far-reaching supervision.³¹⁰

E. *Additional Problems with the New Capital Adequacy Framework*

The new proposal does little to ameliorate the flaws of the 1988 Accord. In addition, the Basle Committee's 1999 proposal may introduce entirely new dilemmas into the already perplexed capital adequacy regime. The sources of these new complications are the use of external rating agencies and the eventual move toward internal credit risk models. Both of these integral components of the Committee's vision of a future capital adequacy regime are severely problematic.

1. Evaluation of Rating Agencies

Many commentators view the infusion of rating agencies into the current framework as a breath of fresh air in a system now stale from regulatory imprecision. "Ratings are a proxy for what the market thinks" about sovereigns, banks, and corporations.³¹¹ Since markets dynamically respond to information and since risk-weighted categories such as those established in 1988 are continually static, rating agencies are far superior in assessing an individual entity's ability to pay its debts.³¹² Even though rating agencies are theoretically presumed to

³¹⁰ See Alain Hirsch, *Supervision of Bank Groups*, TRENDS AND FORCES IN INTERNATIONAL BANKING LAW 62, 72 (1990) ("Faced with the reality of bank groups, national supervisory agencies have been led to realize that separate supervision of different banks in a group is insufficient."); *BIS Reviews Basle Committee Guidelines*, EUR. BANKER, Feb. 24, 1999, available in 1999 WL 11536292 (reporting that "banks are growing to global proportions and more income is being generated from trading and other nontraditional fee-generating areas, risk is becoming much harder to keep track of").

³¹¹ *Basle Accord Revision Looking to Ratings*, CFO ALERT, Nov. 23, 1998, available in 1999 WL 5283722.

³¹² See Phillips & Rechtschaffen, *supra* note 40, at 1762-63 ("[C]redit rating agencies enhance the capital markets infrastructure by distilling a great deal of information into a single credit rating for a security. That rating reflects the informed judgment of the agency regarding the issuer's ability to meet the terms of the obligation."). Some also believe that entities change their risk behavior to avoid getting poor ratings by external agencies. See *supra* text accompanying note 256 (discussing that banks conform their internal credit risk models to a preferred rating by an external agency). Thus, one conclusion is that once banks become fully subject to external credit ratings, they will adjust their capital ratio to receive a better rating. Others suggest that credit rating agencies do not have such a dynamic effect on the entities they assess:

The evidence in support of the hypothesis that banks raise their capital ratios as a response to pressure from rating agencies is inconclusive. All bankers who have been involved with their organisation's contacts with rating agencies know that this is indeed a major topic of discussion, but the empirical evi-

bring greater accuracy to the risk assessment system, their incorporation into a regulatory framework may yield undesirable results.

The first problem with rating agencies is questionable accuracy. Some scholars assert that rating agencies have "had only a mixed track record" at best.³¹³ In fact, commentators have alleged that even the Basle Committee "is aware that rating agencies, in general, have not covered themselves with glory in the recent past while assessing national economies and systems, especially in South-East Asia."³¹⁴

The second problem is that, even assuming *arguendo* that rating agencies are accurate, the worldwide dearth in agencies could retard the proposal's implementation.³¹⁵ Even existing agencies doubt that they could effectively expand operations to meet the needs of bank regulators.³¹⁶

An inherent conflict of interest between the agency and its rated client is a third, and significant, problem. Rating agencies are only successful today because the public is confident in their ability both to accurately and impartially assess individual entities.³¹⁷ The Basle proposal could threaten this equilibrium since "increasing the reliance on ratings for setting prudential standards in bank regulation creates an incentive for ratings agencies to serve the interest of the *borrowers* being rated, and thus subverts the original purpose credit ratings were intended to serve."³¹⁸

A final problem is that excessive dependence on questionable rat-

dence suggests that the link between capital ratios and credit ratings is not as strong as one might think.

MATTEN, *supra* note 23, at 11.

³¹³ Interview with Richard J. Herring, Professor of International Banking and Finance, The Wharton School of Business at the University of Pennsylvania, in Philadelphia, Pa. (Nov. 22, 1999) [hereinafter Herring Interview].

³¹⁴ Venkitaramanan, *supra* note 137; see also *Statement No. 160*, *supra* note 11 ("[R]atings agencies move slowly, and changes in ratings lag changes in actual credit quality, so that the ratings have a questionable ability to predict default. Indeed, the record of the ratings agencies before the recent Asian financial crisis was particularly poor.").

³¹⁵ See *supra* Part III.E (discussing the lack of rating agencies in countries outside the United States and United Kingdom as making the playing field among nations even more uneven).

³¹⁶ See Venkitaramanan, *supra* note 137 ("Most rating agencies are still not equipped adequately to handle large extra load cast on them.").

³¹⁷ See Herring Interview, *supra* note 313 (discussing the circumstances to which rating agencies currently owe their success).

³¹⁸ *Improving the New Framework*, *supra* note 292; see also *Statement No. 160*, *supra* note 11 ("Ratings agencies would have incentives to engage in the financial equivalent of 'grade inflation' by supplying favorable ratings to banks seeking to lower their capital requirements.").

ing agencies will inevitably lead to "regulatory capture" of the banking regulators of individual nations. If the proposal does not result in a more prudent and efficient capital adequacy regime when regulators hand over the reigns of risk-weighting to private enterprises, regulators will have a difficult time repossessing those reigns. In summary, rating agencies may bring further chaos to the international capital adequacy regime because their assessments may be inaccurate, limited in scope, and prejudicial in their appraisals, thus acting as a barrier against swift regulatory intervention.

2. Evaluation of Internal Credit Risk Models

The incorporation of credit risk models into the current capital adequacy framework may initially make banks, national regulators, and the Basle Committee sanguine. Credit risk models would effectively remove the entire hodgepodge of artificial risk weights, desultory capital ratios, vague definitions of capital, and summing of individual asset risks from the realm of capital adequacy regulation. With these internal models delineating risks and allocating capital, "the relevant institutional players in international banking law" could satisfy their interests.³¹⁹ Internal models would provide banks with more leverage in determining which borrowers to select, how best to diversify their portfolios, and how much risk to assume, all contributing to the individual bank's ability "to make money, or to hedge risks so as to avoid losing money."³²⁰ National regulators would supervise the banks' implementation of these internal models without the reproach of the banking industry for enacting rules that are too inflexible. The Basle Committee could escape criticism from both bankers and regulators around the world, while continuing "to retain its status as a highly regarded forum for central bankers."³²¹ With these incentives facing banks, national regulators, and the Committee, it appears that the move toward internal models will be a virtual regulatory utopia for the international banking community.

Credit risk models, however, pose several challenges to achieving a system of effective bank capital regulation. The first problem is that credit risk models are currently unreliable. In studies conducted by both American and European regulators, various credit risk models

³¹⁹ Bhala, *supra* note 4, at 11.

³²⁰ *Id.* at 13.

³²¹ *Id.* at 17.

were not able to withstand the scrutiny of national banking officials.³²² Unlike the legions of bankers working to develop enhanced credit risk models, many regulators believe that "the search for . . . model[s] is a futile one."³²³ One reason why these models are currently unreliable is that "[m]ost of the models on the market tend to extrapolate data and observations from the world's best-developed markets—predominantly the U.S. bond and equity markets—and apply them to markets where the parameters may be completely different."³²⁴ How can such models accurately evaluate the loans made to nations and entities in Asia and other emerging markets? Many simply believe they cannot.

Perhaps one solution for banks using credit risk models is the compilation of "a global database of default and credit history."³²⁵ This solution, however, would require banks to invest an enormous amount of resources, possibly offsetting any benefits derived from these models. A more fundamental cause of the credit models' unreliability is their exclusive reliance on data relating to past events. Since large sectors of the world economy are subject to volatile change, *a fortiori*, most individual firms are even more susceptible to changes in financial conditions. Therefore, any method of evaluating risk that depends on past conditions alone is destined to be imprecise.³²⁶

A second problem with credit risk models is the potential for industry capture of bank regulators.³²⁷ Because of the innate complexity

³²² See FEDERAL RESERVE SYS. TASK FORCE ON INTERNAL CREDIT RISK MODELS, CREDIT RISK MODELS AT MAJOR U.S. BANKING INSTITUTIONS: CURRENT STATE OF THE ART AND IMPLICATIONS FOR ASSESSMENTS OF CAPITAL ADEQUACY 33-34 (May 1998) (discussing the Federal Reserve's finding that credit risk models failed various tests performed by regulators and are not likely to be depended upon to set capital standards); David Shirreff, *Models Get a Thrashing*, EUROMONEY, Oct. 1998, at 31 ("European regulators concluded that the models were 'half-baked' and could not be used to set regulatory capital.").

³²³ *Basle Accord Revision Looking to Ratings*, *supra* note 311.

³²⁴ See Shirreff, *supra* note 322, at 32.

³²⁵ *Id.*

³²⁶ See Mingo, *supra* note 34, at 54 (noting that "'models-based' approaches to capital adequacy could become as ineffective as the traditional ratio-based approaches may now be, and may impose similar unnecessary costs on banks, unless regulators approach the problems of prudential regulation in systematic fashion").

³²⁷ See Darringer, *supra* note 192, at 334 (asserting that while there is a risk that this models-based approach could lead to capture of the bank regulators, the Basle guidelines and audit procedures should prevent industry capture). With regard to the assessment of market risk of various derivative instruments, recent amendments have permitted banks to use internal risk models. See BASLE COMM. ON BANKING SUPERVISION, AN INTERNAL MODEL-BASED APPROACH TO MARKET RISK CAPITAL REQUIREMENTS (Apr. 1995) (discussing the use of internal models in determining

of these models, bank regulators may fail to understand the model's intricacies, effectively handing the reigns of regulation over to the regulated banks themselves.³²⁸ That individual banks may use their own distinct models will compound this problem.³²⁹ If regulatory bodies wish to adequately supervise banks' use of internal models, they will have to increase the size and improve the skills of their staffs, thereby creating an additional burden on taxpayers financing the regulatory regime. Additionally, since internal models are considered intellectual property, their inner workings are shrouded in the utmost secrecy. Only bank regulators, not members of the general public, would have the opportunity to learn how such models operate. This may give rise to an ancillary basis of regulatory capture. "When information about internal risk management is not made public, and when the determination of the reasonableness of bank risk estimates remains in the hands of bank regulators, the possibility of regulatory forbearance must be considered a distinct possibility."³³⁰ Therefore, the Basle Committee should reconsider the incorporation of credit risk models into a future capital adequacy framework since the models' accuracy is doubtful and the risk of regulatory capture is great. What may seem to be a more efficient means of conducting capital allocation may be more costly and risky for participants in this multi-billion dollar regulatory regime.³³¹

market risk). These models must be regulated by audit and other procedures. Credit risk, however, is one of the major problems facing banks today. The use of credit risk models would provide far more power to banks in determining adequate capital than using models to measure only market risk.

³²⁸ See Taylor, *supra* note 37, at 802 (noting that "the supervisory community generally lacks the human resources to be able to monitor the more sophisticated risk management systems").

³²⁹ See MATTEN, *supra* note 23, at 51 ("[I]mbalance[s] between internal and external models makes it very difficult for the internal model to be simply a more accurate version of the regulatory model, with higher levels of granularity.").

³³⁰ *Improving the New Framework*, *supra* note 292; see also *The Basle Committee's New Capital Adequacy Framework*, *supra* note 305 (noting that "it is likely to be politically and economically difficult for government agencies to penalize banks when they suffer losses and become undercapitalized, particularly when information about bank compliance remains solely in the hands of the regulators").

³³¹ See Arturo Estrella, *Formulas or Supervision? Remarks on the Future of Regulatory Capital*, *ECON. POL'Y REV.*, Oct. 1998, at 192 (arguing that "scarce public resources are better employed to enhance supervision than to develop new formulas whose payoff may be largely illusory"); Mingo, *supra* note 34, at 54 (asserting that "models-based" approaches to capital adequacy could become as ineffective as the traditional ratio-based approaches may now be, and may impose similar unnecessary costs on banks, unless regulators approach the problems of prudential regulation in systematic fashion"); Shirreff, *supra* note 322, at 32 (remarking that "modellers [are metaphorically] in search of the holy grail").

V. THE SHADOW COMMITTEE PROPOSAL

The Basle Committee's lead role as a promulgator of international soft law has led not only bankers and lawyers, but also academics, to pay careful attention to its pronouncements. For approximately fifteen years,³³² a committee of American law professors and economists engaging in "research or practicing in the field of finance" has met periodically to evaluate financial regulations.³³³ This group, now referred to as the Shadow Committee, gathers its members "from academic institutions and private organizations and reflect[s] a wide range of views."³³⁴ The Shadow Committee thus represents a group of disinterested scholars seeking to ensure that the international banking system is regulated in a manner that promotes both efficiency and safety.³³⁵ The success of the Committee's activities, primarily its exhaustive evaluation of public policy proposals by governments and other influential bodies, has led to the establishment of sister committees in Europe and Japan.³³⁶ The American Shadow Committee recently proposed an alternative to the 1999 Basle Committee's *New Framework*. Because of the Shadow Committee's respect and influence in the international financial community,³³⁷ its alternative proposal has attracted the attention of the international banking community.

³³² See Herring Interview, *supra* note 313 (discussing the number of years the U.S. Shadow Committee has existed).

³³³ Shadow Fin. Regulatory Comm., *About the Shadow Financial Regulatory Committee* (visited Dec. 1, 1999) <<http://www.aei.org/shdw/shdw.htm>> [hereinafter *About the Shadow Committee*].

³³⁴ Shadow Fin. Regulatory Comm., *Shadow Financial Regulatory Committee: Statement of Purpose* (visited Dec. 1, 1999) <<http://www.aei.org/shdw/shdwpur.htm>>.

³³⁵ See *id.* (laying out the Shadow Committee's goals).

³³⁶ See Shadow Fin. Regulatory Comm., *European Shadow Financial Regulatory Committee—A New Initiative* (visited Dec. 1, 1999) <<http://www.aei.org/shdw/shdweuro.htm>> (describing the European Shadow Financial Regulatory Committee ("ESFRC") as a "group of European professors and experts in the field of banking, finance, and regulation of financial services").

³³⁷ The Shadow Committee is composed of such notable scholars as George J. Benston of Emory University, Charles W. Calomiris of Columbia University, Franklin R. Edwards of Columbia University, Scott E. Harrington of the University of South Carolina, Richard J. Herring of the University of Pennsylvania, Paul M. Horvitz of the University of Houston, George G. Kaufman of Loyola University Chicago, Robert E. Litan of Brookings Institution, Roberta Romano of Yale Law School, Hal S. Scott of Harvard Law School, Kenneth E. Scott of Stanford University, and Peter J. Wallison of the American Enterprise Institute. See *About the Shadow Committee*, *supra* note 333 (listing the committee members).

A. *The Basics: The Uninsured Subordinated Debt Requirement*³³⁸

One of the seven deadly sins of the original Basle Accord is its chief premise that equity holdings form a superior cushion to debt holdings.³³⁹ Although common equity is more perpetual than debt instruments, shareholders' incentives may not always align with the most prudential risk management.³⁴⁰ The Shadow Committee's proposal relies on this principle as the foundation of its suggested approach to bank capital regulation. The proposal states that "[c]urrent regulatory capital standards clearly err by discriminating against subordinated debt and preferred stock as components of bank capital."³⁴¹ Increasing the cast of debtholders in the context of capital adequacy regulation will generate two potential benefits.

The Shadow Committee believes that subordinated debtholders will themselves become "risk disciplinarians of banks," and that regulators will accrue significant information rendered by "market signals from subordinated debt yields."³⁴² The reason that debtholders would assume a disciplinarian role is simple. If a bank increases its portfolio risk without concurrently increasing its capital cushion, when the bank itself attempts to borrow by taking a loan or issuing a bond, the bank's new creditors will demand higher interest rates commensurate to the bank's risk profile. Prospective lenders may also refuse to loan

³³⁸ Subordinated debt is a "debt that can only be claimed by an unsecured creditor, in the event of a liquidation, after the claims of secured creditors have been met." SCOTT & WELLONS, *supra* note 8, at 1249; *see also* Alford, *supra* note 26, at 190 ("Subordinated debt includes interest-bearing obligations that pay a fixed amount at a future date."). The term "uninsured" simply means that the subordinated debtholders will not be reimbursed for losses by a deposit insurance regime in the event of the borrowing bank's insolvency. *See* Shadow Proposal, *supra* note 11, at 40 (stating that truly uninsured debt demands that the instrument not be subject to one of the "mechanisms for bailing out" its holders (i.e., debt insurance)).

³³⁹ *See supra* text accompanying notes 178-80 (explaining that debtholders may have more incentives to insist that bankers do not issue risky loans).

³⁴⁰ *See supra* text accompanying notes 178-80 (noting that debtholders have a limited upside for their investments and cannot expect higher returns on their investments when the bank takes risks like shareholders can).

³⁴¹ Shadow Proposal, *supra* note 11, at 29. The Shadow Committee also summarizes the principal reason why debt may serve as a better cushion than common equity:

The incentives of debtholders are different because they hold a fixed income claim. A fixed income claim does not entitle debtholders to share in upside gains beyond their coupon payments, as shareholders do. Increased asset risk benefits shareholders of insured banks when capital is low or negative and deposit insurance is underpriced, but always hurts uninsured debtholders because higher risk increases the probability of their not being fully repaid.

Id. at 30.

³⁴² *Id.*

to the bank entirely, thus confining the bank's means of funding to the costly issuance of equity or other securities.³⁴³ Just as regular depositors want the bank to maintain a prudent risk profile, debtholders also want the bank's asset risk to remain conservative, ensuring that repayment is virtually doubtless. Since a major policy rationale of the capital adequacy regime is to protect "depositors in the event of bank insolvency,"³⁴⁴ the introduction of disciplinarians—supplementary to governmental authorities—whose economic interests are aligned with deposit insurance agencies, would strengthen existing regulations.³⁴⁵ This would not be the only dynamic effect of increasing the role of uninsured subordinated debtholders into the current Basle framework.

The second benefit stems from the fact that debtholders will not discipline banks in private. The discipline imposed on banks by their lenders will be visible to regulators by the interest rates of the debt instruments. The greater the interest rate, the more precarious the debtholders perceive the bank's assets to be. Hence, "high yields produce an audible, undeniable 'cannon shot' heard by all."³⁴⁶ Since multiple market participants will appraise the borrowing bank's entire risk environment, interest rates are likely to reflect more precisely the bank's actual degree of solvency. "Market yields on bank debt will reflect the risks banks are taking whether those risks appear on the balance sheet or reside off the balance sheet, and whether they are implicit or explicit."³⁴⁷ Therefore, regulators could monitor yields on a bank's uninsured subordinated debt, using such information in their assessment of whether the bank is holding adequate capital.³⁴⁸

³⁴³ See *id.* at 30-31 ("[I]f a bank suffered losses of asset value and increases in asset risk, vigilant subordinated debtholders . . . would discipline the bank by raising the cost of finance, curtailing the amount of finance, or requiring the bank to act in credible ways to reduce asset risk or raise equity.").

³⁴⁴ Alford, *supra* note 26, at 191.

³⁴⁵ See Shadow Proposal, *supra* note 11, at 30 ("The incentives of uninsured debtholders in measuring and penalizing risk are aligned with the deposit insurer, not the bank shareholders."); see also *Statement No. 160*, *supra* note 11 ("[T]he presence of subordinated debt reduces banks' incentives to take on inappropriate risks because, for solvent banks, the incentives of the subordinated debt holders and the deposit insurance agency are aligned.").

³⁴⁶ Shadow Proposal, *supra* note 11, at 50; see also *Statement No. 160*, *supra* note 11 ("[I]ncreases in the interest yield on existing traded debt provide a warning from investors of the risks banks are taking.").

³⁴⁷ Shadow Proposal, *supra* note 11, at 32.

³⁴⁸ According to the Shadow Committee, "The decisions of subordinated debtholders would provide powerful information about bank risk to supervisors and regulators, and to the public at large, thus facilitating the management of risk and capital

The Shadow Committee asserts that imposing a mandatory uninsured subordinated debt requirement will not overly burden regulated banks. In fact, it has publicly stated that "it is highly unlikely that the annualized issuing costs of subordinated debt would be as high as those of equity."³⁴⁹ In many nations, interest payments to debtholders are excluded from taxable income.³⁵⁰ The banking system as a whole may also benefit from a potential transformation from book value accounting to market value accounting.³⁵¹ The two main benefits of debtholders playing a more central cast in capital adequacy regulation, along with the aforementioned secondary advantages, has led the Shadow Committee to support the addition of an uninsured subordinated debt requirement to the current Basle Accord. More specifically, the Shadow Committee has proposed "a minimum subordinated debt requirement of 2% of non-cash assets."³⁵²

B. *The Specifics: Additional Regulations*

Simply amending the current capital adequacy guidelines to require banks to hold uninsured subordinate debt will be insufficient to secure the benefits of the Shadow Committee's proposal. Adequate legal safeguards must also accompany the new 2% debt obligation. There are two major obstacles to establishing a successful uninsured subordinated debt requirement. First, the uninsured debt must be

standards by regulators." *Id.* at 31.

³⁴⁹ *Statement No. 160, supra* note 11. The Shadow Committee conducted a study comparing the costs of issuing equity to issuing subordinated debt for large U.S. banks during the period of 1995-1999. The results support the contention that equity is a more expensive form of capital for banks.

The present value of issuing costs for bank subordinated-debt offerings sold to the public averaged 1.53 percent of offerings. The average issuing cost for common stock offerings sold to the public for the same sample of banks was 3.46 percent. Thus, the transaction costs of subordinated-debt offerings are less than half those of common stock offerings for large U.S. banks.

Id.

³⁵⁰ See Shadow Proposal, *supra* note 11, at 34 (stating that "because of the deductibility of interest payments . . . [there is a] tax advantage favoring subordinated debt"). But see Alford, *supra* note 26, at 211 ("The disadvantage of subordinated debt over equity is that bank operating income is decreased by the interest charges on the debt.").

³⁵¹ See Shadow Proposal, *supra* note 11, at 33 (noting that a "deep market in uninsured bank debt would produce a new demand for clear accounting").

³⁵² *Id.* at 47. The Shadow Committee proposes that uninsured subordinated debt have a minimum maturity with maturity dates evenly spaced. See *id.* at 48 ("A minimum maturity is necessary to limit the ability of subordinated debtholders to flee without bearing losses when banks suffer losses on assets."); see also *Statement No. 160, supra* note 11 (proposing that "large banks be required to back at least 2 percent of their outstanding assets and off-balance-sheet commitments with subordinated debt").

truly uninsured. If debtholders believe that the government will bail them out when the bank becomes insolvent, the moral hazards of deposit insurance will encourage debtholders to lighten their role as disciplinarians.³⁵³ The Federal Deposit Insurance Corporation ("FDIC") is permitted under federal law to pay holders of bank subordinated debt in the event of the issuer's insolvency.³⁵⁴ To make the uninsured debt requirement workable, "any payments from the FDIC to the holders of mandated subordinated debt should be legally prohibited."³⁵⁵ Other nations with similar deposit insurance frameworks also would have to curtail payments to subordinated debtholders included in the 2% requirement.

In addition to the possibility that deposit insurance agencies could ruin debtholders' incentives to discipline banks, there lies another potential dilemma. Under the Shadow Committee's proposal, banks will have a vested interest to maintain low yields on their subordinated debt. There are two ways banks can accomplish this. First, banks can act prudently in allocating risk and conducting their transactions. Regulators implementing the proposal will try to foster this method of achieving low yields. Secondly, banks can purchase their own debt at an inflated value in order to avoid high interest rates or, alternatively, can collude with other banks.³⁵⁶ It is evident that artificial pricing of debt by banks could block the effectiveness of the proposed 2% re-

³⁵³ See Shadow Proposal, *supra* note 11, at 40 (contending that "for subordinated debt (or any uninsured debt) issued by a bank to be a source of market discipline, and for its yield to reflect market perceptions of default risk, that debt must be *credibly uninsured*"). Deposit insurance often impairs market discipline by providing participants with an ultimate safety net. See Ransom, *supra* note 308, at 447 ("Deposit insurance 'gets in the way of the depositors signaling a bank when it takes excessive risks.'" (quoting Laurence H. Meyer, *The Transformation of the U.S. Banking Industry and Resulting Challenges to Regulators: Speech Before the Ohio Bankers Day Conference* (Nov. 21, 1996), available in Federal Reserve Bd., *FRB: Federal Reserve Board Speech from 11/21/96* (visited May 22, 1998) <<http://www.bog.frb.fed.us/BOARDDOCS/SPEECHES/19961121.htm>>)).

³⁵⁴ See 12 U.S.C. § 1823(c)(4) (1994) (specifying the limits on the FDIC's ability to reimburse subordinated debtholders). The current rule is rather complicated:

The FDIC may only do so if the cost to it of the assisted acquisition does not exceed the cost of a bank liquidation, which is defined as the sum of insured deposits minus the present value of the total net amount to be reasonably expected from a straight liquidation.

Shadow Proposal, *supra* note 11, at 41.

³⁵⁵ Shadow Proposal, *supra* note 11, at 41.

³⁵⁶ See *id.* at 43 ("By purchasing their bank's debt at a price above its true value the owners would both lose and gain equal amounts on the transaction, so overpaying for its debt would entail no net cost. . . . [and would] permit a weak or insolvent bank to appear strong . . .").

quirement. Additional regulation is necessary to ensure that all transactions involving the mandatory subordinated debt are done at arms-length, effectively restraining the ability of banks to engage in self-dealing.³⁵⁷ The mainstay of this supplementary regulation would require banks to disclose the various parties with whom they have dealt respecting debt issues.³⁵⁸

Apart from supplementary regulations intended to achieve the twin goals of the subordinated debt requirement, namely, increasing market discipline and market signaling, the Shadow Committee proposes other changes to the current Accord as well. First, it calls for a revision of the 8% capital ratio established in 1988 to a 10% ratio of capital to non-cash assets.³⁵⁹ Some economists have criticized the current ratio for being too small.³⁶⁰ Second, it calls for the dissolution of the two-tiered system currently in place, replacing it with a general capital requirement using the mandated, uninsured, subordinated debt comprising 2%.³⁶¹ Third, the Shadow Committee's proposal petitions for the "elimination of risk weights on assets," and calls for "the use of a uniform 100% risk weight for all non-cash assets."³⁶² Although this amendment is perhaps the most radical of the Shadow Committee's departures from the Basle framework, the change is justified on the grounds that "risk weights [would] no longer distort bank decision

³⁵⁷ To avoid this problem, the Shadow Committee proposes: [Regulators should] require that purchasers of subordinated debt be entities that have no direct or indirect connection to the issuer. . . . [B]orrowers from the bank, affiliates within the issuing bank's holding company, firms managed or owned by major shareholders of the issuing bank, or firms with other significant dealings with the bank . . . should be prohibited from purchasing its subordinated debt.

Id.

³⁵⁸ See *id.* at 44 ("Disclosure requirements that require that holders disclose their identity to regulators would facilitate enforcement of the arms-length holding requirement.").

³⁵⁹ See *id.* at 36 (asserting that "10% is a conservative estimate of what the market would require"); see also *Statement No. 160*, *supra* note 11 ("Accordingly, we recommend that regulators raise the requirement—at least for large banks—to something on the order of 10 percent of (unweighted) on-balance-sheet assets and off-balance-sheet commitments.").

³⁶⁰ See, e.g., MYRON L. KWAST & WAYNE PASSMORE, FEDERAL RESERVE BD., *THE SUBSIDY PROVIDED BY THE FEDERAL SAFETY NET: THEORY, MEASUREMENT AND CONTAINMENT* 27-29 (1997) (discussing that financial institutions in the United States that are similar to banks maintain, on average, a capital ratio greater than 10%).

³⁶¹ See Shadow Proposal, *supra* note 11, at 3 (stating the Shadow Committee's commitment to "eliminating the distinction between Tier 1 and Tier 2 capital").

³⁶² *Id.* at 34; see also *Statement No. 160*, *supra* note 11 ("Accordingly, we favor the elimination of regulatory risk weights on assets, on and off the balance sheet.").

making as they have in the past . . . [and that] the risks banks would create would be measured and penalized by subordinated debtholders."³⁶³ The paradigm of regulation proposed by the Shadow Committee would require much less supervision from national regulators because subordinated debtholders will serve as the primary disciplinarians.

The implementation of the 2% uninsured subordinated debt requirement would simplify the monitoring and enforcement process of bank regulators. Since yield rates on the debt would reflect the bank's credit risk, regulators would promptly receive notice of large deviations in credit risk. To ensure that a bank's insolvency risk did not reach an exceedingly precarious rate, national regulators, or even the Basle Committee, could establish a maximum yield spread.³⁶⁴ Periodically, bank regulators would have to examine the disclosure documents of the banks, as well as complete audits to ensure the nonexistence of self-dealing and the bank's compliance with all other restrictions.³⁶⁵ If a bank failed to remain within its maximum yield spread, regulators could impose sanctions commensurate to the quantitative violation of the spread and intervene quickly to prevent insolvency.³⁶⁶ The Shadow Committee proposal thus attempts to solidify

³⁶³ Shadow Proposal, *supra* note 11, at 35. In its most recent public statement, the Shadow Committee remained fervent in its stance to eliminate the current risk-weight categories of the Basle Accord:

[A] limit on leverage, without the complication of risk weighting, has the advantage of greater simplicity and is less misleading, since it does not purport to weigh the relative risks associated with broad categories of assets. Moreover, a straightforward leverage requirement reduces banks' incentives to manipulate required capital by shifting assets among risk-weight categories, when those shifts do not represent real changes in portfolio risk.

Statement No. 160, supra note 11.

³⁶⁴ "A maximum yield spread would force adjustment to take place in quantities, not just prices, and thus would have an automatic stabilizing effect on the permissible level of risky assets in the bank." Shadow Proposal, *supra* note 11, at 50. In its most recent public statement, the Shadow Committee has proposed the following bright-line rule for tracking yield spreads. "Whenever, for three consecutive months, the yield on the qualifying subordinated debt of a bank rises above the yield of moderately risky corporate bonds (say, those rated BBB or Baa) with similar maturity, the bank is considered to be in violation of its subordinated-debt requirement." *Statement No. 160, supra* note 11.

³⁶⁵ See Shadow Proposal, *supra* note 11, at 39 ("Supervisors would ascertain the existence of bona fide outstanding subordinated debt contracts that satisfy the law's requirements.").

³⁶⁶ The Shadow Committee recognizes that the insured subordinated debt requirement will lead to quicker intervention among regulatory authorities. "Structured early intervention and resolution, as codified in the United States under FDICIA, provides a powerful tool for holding banks accountable to regulations, and is particularly

the partnership between market participants and regulators in ensuring that banks maintain adequate capital. In essence, this alternative contends that “private market discipline *can* be used by the government: to restrict default risk, to price default risk, and to penalize default risk.”³⁶⁷

SUMMARY OF SHADOW COMMITTEE PROPOSED STANDARDS

*Characteristics of Mandatory Debt Issues*³⁶⁸

Type of Uninsured Debt – Subordinated debt
 Required Amount – 2% of non-cash assets (on- and off-balance sheet)
 Maturity at Date of Issue – Minimum of 2 years, Maximum of 3 years,
 Maturity extendable
 Spacing of Maturing Offerings – Limit bunching of maturity dates
 Use of Yield Spreads –
 Vary deposit insurance fees with observed yield spreads
 Trigger regulatory intervention penalties
 Trigger extension of maturity on maturing sub. debt
 Maximum Yield Spread – At issue date yield spread < current average
 BBB yield
 Arms-length Requirement – Qualifying sub debt cannot be held by
 borrowers, affiliates, or shareholders debt requirement (based on
 asset size)

*Accompanying Regulations*³⁶⁹

Least Cost Resolution – If LCR is invoked, qualifying subordinated
 debtholders receive nothing from FDIC or from issuing bank
 Disclosure of Holders – Holders of debt must disclose that they have
 purchased debt and must affirm no connection to issuer (with
 criminal penalties for fraud)
 Repeal of Tier 1, Tier 2 – Banks would face minimal capital require
 ment of 10%
 Repeal of Risk Weighting – Capital requirement set relative to total
 non-cash assets

valuable for enforcing quantitative rules The Shadow Committee recommends the adoption of similar provisions in other countries.” *Id.* at 52.

³⁶⁷ *Id.* at 37 (emphasis added).

³⁶⁸ *Id.* at 60.

³⁶⁹ *Id.*

C. *Evaluation of the Shadow Proposal*

The Shadow Committee's proposal is distinctly the work of scholars who have meticulously examined the international system of bank capital regulation from a theoretical perspective. The proposal attempts to align regulatory goals with elemental market realities. It rectifies many of the flaws rampant in both the current standards and the Basle Committee's *New Framework*. The Shadow Committee's proposal harnesses the benefits stemming exclusively from the debt form of regulatory capital. For some time, practitioners and scholars have claimed that "bank issuance of subordinated debt should be encouraged because it is precisely the holders of these instruments who are most likely to monitor and [be] least affected by moral hazard."³⁷⁰ The proposal also proffers a new capital ratio of 10% with at least some analytical research to support the figure. The playing field may become more even since insured subordinate debt is an uncomplicated instrument that all banks in every country could issue. Battling among nations over what constitutes Tier 1 capital will cease when the tiered system is eliminated.

The Shadow Committee proposal expunges the inflexible and widely scorned risk-weight categories set forth in the 1988 Accord from the regulatory regime. Unlike the Basle Committee, which has proposed to delegate risk-weighting duties to external rating agencies and the banks themselves, the Shadow Committee proposes a uniform risk weight.³⁷¹ Problems stemming from external rating agencies and credit risk models, such as dependability and regulatory capture, will not occur since the main disciplinarians, uninsured subordinated creditors, possess incentives that naturally align with regulators rather than the regulated. Furthermore, the regulatory supervision of yield spreads is much less burdensome than the examination of rating agency qualities, internal ratings-based systems, and intricate financial risk models. Regulators could "increase reliance on market discipline" while simultaneously ensuring that bank capital is sufficient to cushion against credit risk.³⁷² In a larger sense, the Shadow Commit-

³⁷⁰ Darringer, *supra* note 192, at 335.

³⁷¹ See *supra* text accompanying note 362 (discussing the uniform 100% risk weight).

³⁷² *Basle Reforms Overdue*, *supra* note 150; see also Joseph J. Norton & Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership"*, 16 ANN. REV. BANKING L. 227, 229 (1997) (arguing that, in the optimal capital adequacy regime, "regulatory and market participants must interact compatibly, on an interdisciplinary basis, to provide an appropriate environ-

tee's implicit abandonment of deposit insurance is a key step on the path toward market discipline of the banking industry.³⁷³

Although the Shadow Committee proposal ameliorates many defects of the current capital adequacy regime that the *New Framework* fails to address, this proposal also poses several dilemmas. First, its total elimination of risk weighting is questionable. Even if the current categories are artificial and somewhat inaccurate assessments of asset risk, there are still significant risk differences that generally can be attributed to assets on the basis of both the type of instrument and the type of borrower.³⁷⁴ When classifications of assets do not overlap entirely with market realities of asset risk, regulatory arbitrage is certain to occur. The risk-weighting of all non-cash assets at a flat 100% may nurture even more arbitrage, since the least risky assets will require the same amount of capital backing as the most risky. In one sense, the Shadow Proposal may expand the hiatus between the regulatory measures of risk and actual asset risk.

The Shadow Committee concedes that the fruition of its proposed elimination of risk weights is "hard to judge" and acknowledges the regulatory impossibility of truly assessing "the relative amounts of risk across categories of assets or activities."³⁷⁵ Furthermore, the Shadow Committee argues that the role of risk weights nevertheless will diminish anyway, since "the risks banks would create would be measured and penalized by subordinated debtholders."³⁷⁶ Relying too much on subordinated debtholders may exude a confidence in market information which may or may not be consistently present.

ment for the necessary formation of a new regulatory-market 'partnership').

³⁷³ See Taylor, *supra* note 37, at 805 ("The movement towards relying on greater use of market forces and self-regulation can only be carried so far if there remains an explicit (or even implicit) taxpayer guarantee against the consequences of firm failure.").

³⁷⁴ For example, there is generally more risk associated with uncollateralized loans than those that are fully collateralized, and generally it is riskier to loan to private business than to a central government.

³⁷⁵ Shadow Proposal, *supra* note 11, at 35.

³⁷⁶ *Id.* In its most recent public statement, the Shadow Committee has argued that the subordinated-debt requirement will reduce regulatory arbitrage regardless of the risk-weighting system in place.

Banks would not benefit from moving assets off balance sheet or by creating off-balance-sheet derivatives risks, because the private market (which is often in a superior position to identify the risks of those off-balance-sheet transactions) should incorporate those risks into the pricing of the bank's subordinated debt. Thus, off-balance-sheet transactions that increase risk will be penalized by the market and, if the regulators rely on market signals to measure risk, by the regulators as well.

Statement No. 160, supra note 11.

A second questionable component of the Shadow Proposal is its revision of the 8% capital ratio to 10% of all non-cash assets. At first glance, the 10% figure seems just as desultory as the Basle Committee's own ratio. The Shadow Committee, however, supports this revision for two main reasons. American banks historically had maintained capital ratios of well above 10% until the establishment of the Federal Reserve and the FDIC.³⁷⁷ Recent studies illustrate that non-regulated financial services companies also currently carry capital ratios of well-above 10%.³⁷⁸ Although an analytical evaluation of the Shadow Committee's argument is beyond the reach of this Comment, its suppositions raise important questions. The fact that capital ratios were well above 10% prior to the 1930s is not determinative that an optimal capital ratio would be higher than 8% today. After all, the very first banks, goldsmiths, kept a 100% capital cushion.³⁷⁹ It should be no surprise that after hundreds of years of technological advancements in payment systems and internal controls, the level of bank capital required has decreased enormously. These same advancements have probably continued to reduce the optimal capital level since the 1930s.³⁸⁰ The Committee's data about unregulated financial institutions also may be indeterminate. Financial services firms may engage in inherently riskier activities, such as investment banking and other more comprehensive derivative transactions in which banks do not regularly engage.³⁸¹ These other institutions, therefore, may require higher capital ratios than banks.

A third problem with the Shadow Proposal is that monitoring costs will increase in conjunction with the subordinated debt requirement. The Shadow Committee even concedes that its plan could result in "higher private market monitoring costs, and the greater dif-

³⁷⁷ See Shadow Proposal, *supra* note 11, at 7 (discussing capital ratios of U.S. banks for the past hundred years).

³⁷⁸ See *id.* at 36 (stating that "U.S. finance companies today—which share functional and structural features of banks, but do not enjoy safety net protection—maintain capital ratios that typically exceed 10% of assets").

³⁷⁹ See SAMUELSON & NORDHAUS, *supra* note 1, at 489 (noting that originally bankers were goldsmiths who kept the entire stock of gold on hand until repayment).

³⁸⁰ Because federal deposit insurance has skewed the true optimal market level of capital, we cannot prove this assertion. The Shadow Committee concedes that after the full implementation of the "federal safety net," the optimal capital ratio has "settled in the 6% to 8% range." Shadow Proposal, *supra* note 11, at 11.

³⁸¹ With the recent constructive repeal of the Glass-Steagall Act, see Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101, 113 Stat. 1338 (1999), however, banks may become indistinguishable from other financial institutions, thus strengthening the Shadow Committee's position.

ficuity in tracking holders of debt to ensure that it is held at arm's-length.³⁸² Although the subordinated debt requirement would give rise to certain monitoring costs, the total cost outlay by regulators may be less under this proposed regime than under the Basle Committee's *New Framework*. Since the Basle Committee's proposal would require a perpetual examination of rating agencies, internal rating systems, and possibly numerous credit risk models, regulatory vigilance over debt yields and debtholders may not produce greater costs. Thus, cost reductions in other areas of supervision may actually offset the costs created by the subordinated debt requirement.

A final difficulty with the subordinated debt requirement is the numerous other laws necessary to secure the proposal's effectiveness. Whereas the Basle Committee's proposal would require regulatory changes implemented mainly by the central banks, the Shadow Committee's proposal demands legislative action outside of the ambit of central banking authorities such as the Federal Reserve. For instance, the proposal may require curtailing the bailout capacities of the Federal Deposit Insurance Corporation under section 12 of the United States Code.³⁸³ Along with this possible statutory change, the Shadow Committee believes that arms-length disclosure requirements should accompany a "criminal law sanction for persons acting in concert with the bank or its owners" who violate provisions supplementing the subordinated debt requirement.³⁸⁴ These statutory changes would require acts of Congress, possibly hampering a prompt establishment of the proposal's provisions. One of the most notable virtues of the 1988 Accord was the manner in which it was efficiently incorporated into the capital adequacy regimes of so many nations. This was due to the fact that many national governments granted their respective central banks sole discretion to issue capital adequacy regulations.³⁸⁵ In many nations, however, the deposit insurance regime may be separated from the central bank or agency that institutes bank capital stan-

³⁸² Shadow Proposal, *supra* note 11, at 46.

³⁸³ See *id.* at 41-42 (discussing the FDIC's power under 12 U.S.C. 1823(c)(4) to bail out subordinated debtholders and what means should be taken to eliminate this possibility).

³⁸⁴ *Id.* at 44.

³⁸⁵ See generally *supra* Part III.D (discussing the reasons for the prompt incorporation of the 1988 Accord into national regulatory regimes). The U.S. Congress has explicitly delegated rulemaking authority to the Federal Reserve in the realm of capital adequacy. See International Lending Supervision Act of 1983 ("ILSA"), Pub. L. No. 98-181, tit. IX, § 908(a)(2), 97 Stat. 1278, 1280 (codified at 12 U.S.C. § 3907 (1994)) ("Each appropriate Federal banking agency shall have the authority to establish such minimum level of capital for a banking institution . . .").

dards.³⁸⁶ Therefore, the Shadow Committee proposal, although superior to the *New Framework* in many respects, may be much more difficult to implement fully in the international arena.

CONCLUSION

The epoch of capital adequacy regulation has been marked by the promulgation of well-intentioned but ill-advised rules by banking regulators around the world. The Basle Committee has essentially succeeded in unifying national bank capital regulation. Unfortunately, the 1988 Accord was wrought with so many flaws that its ubiquitous rules induced omnipresent dilemmas. In the summer of 1999, the Basle Committee introduced its *New Framework*, an alternative regulatory regime designed to replace the Accord. The Committee's proposal fails to repair many of the original defects of the 1988 Accord and introduces additional problems as well. The U.S. Shadow Committee also has proposed an alternative to the current capital adequacy regime which relies in large part upon the disciplinary and informational qualities of uninsured subordinated debt. This is the best regulatory alternative to the 1988 Accord. The Shadow Proposal's requirements of additional legislative action, however, may make it burdensome to implement. Perhaps the underlying problem is that government attempts to adequately regulate bank capital are doomed from their initiation.

Government officials have not accorded the possibility of deregulation the keen attention it deserves. In treating banks differently from other corporations by mandating capital ratios, regulators have denied the reality that "little is known about insolvency probability."³⁸⁷ Furthermore, "economists have found no statistical correlation between bank capital levels and bank failures."³⁸⁸ Still, regulators continue to argue that rules governing bank capital are sure to prevent widespread financial crises. Regulators, however, have lost some ground. Both the *New Framework* and the Shadow Proposal acknowledge that "regulators and supervisors are not as skilled in measuring

³⁸⁶ See Joseph J. Norton, *Structuring the Banking Regulators and Supervisors: Developed Country Experiences and Their Possible Implications for Latin America and Other Developing Countries*, NAFTA: L. & BUS. REV. AM., Summer 1998, at 5, 9-12 (highlighting that in many countries promulgation and supervision of aspects of capital adequacy rules are split among the central bank and other agencies).

³⁸⁷ Mingo, *supra* note 34, at 52.

³⁸⁸ Darringer, *supra* note 192, at 259.

risk as market participants.”³⁸⁹ The Basle Committee’s eventual authorization of internal credit risk models is an indication that regulators are surrendering to market processes. Nevertheless, when banks maintain capital on the basis of regulatory rather than market demands, only detrimental results will follow:

First, inappropriate capital requirements will induce a misallocation of capital resources within the banking industry, as well as between bank and non-bank commercial sectors. Second, they will induce distortions in bank pricing and business decisions, resulting in a misallocation of resources due to balance sheet restructuring. Third, they may cause a global credit crunch. Fourth, they may induce banks to increase portfolio risk or acquire the riskiest assets within each asset classification. Last, setting inappropriate capital requirements will drive certain business from the regulated sector to the unregulated sector.³⁹⁰

Despite a trend toward integrating regulatory and market processes, the mainstay of the next Basle Accord, whether it resembles the *New Framework* or the Shadow Proposal, will still require banks to maintain a rigid capital ratio. It is no wonder why so many bankers, lawyers, and scholars are continually questioning the adequacy of international capital adequacy rules.

³⁸⁹ Shadow Proposal, *supra* note 11, at 31.

³⁹⁰ Darringer, *supra* note 192, at 330.

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