The Transnational Test:
Can Basel II Really Define Uniform Standards Around the World?

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In a speech earlier this week, the Chairman of the U.S. House's Financial Services Committee, Mike Oxley, commented that everyone favors competition as long as they get to win in it. He likened this to the fact that everyone wants to go to heaven, but no one wants to die to get there. This is, I think, a lot like transnational financial industry regulation – it sounds fine until a transnational agreement limits national discretion.

This has in practice made transnational rules so hard that few, if any, have actually been implemented. I would argue that many of the rules on today's agenda are transnational not by design, but rather by impact. By this I mean that the EU's various financial directives were written by the EU for the EU. Their transnational impact comes because many firms operating in the EU are, of course, housed somewhere else. In an era of complex global financial organizations, standards written in the EU – or, for that matter, the U.S. – reach beyond the borders for which they are designed like it or not. This raises an array of home/host issues and still broader policy questions already very well addressed in earlier presentations. However, we are still left with the fundamental question initially before us: is it possible to design financial-sector rules that can in fact create an equitable framework that unifies the proverbial playing field across national borders?

In my opinion, the Basel II Accord is an excellent test case and, so far, the prospects are not encouraging. I shall describe Basel II in more detail, but let me here say that – like its predecessor set of global bank risk-based capital standards (Basel I), Basel II is a top-down transnational rule. That is, it has been written by regulators from all of the Group of Ten (G-10) countries as a set of capital, supervisory and disclosure standards intended to apply in the same way at the same time to every banking organization in each of the participating countries. It's taken dozens – possibly hundreds – of bank regulators almost a decade to finalize the lengthy final Accord released last June. Despite all this work in a most worthy endeavor, though, I think the initial results are not promising for a truly transnational regulatory framework. Basel II is thus an important cautionary tale. It tells us, I think, that transnational rules structured from the start to reach across borders will only work if structured as clear principles backed by express enforcement. Extremely complex standards backed by very different enforcement regimes with widely varying clout – Basel II, in short – will quickly break apart.

Basel Basics

One bank recently said that at least 1,000 personnel now are working full time on Basel II implementation. Studies have suggested that the new capital rules will cost big institutions at least $100 million to implement – that's for systems, not the cost of any capital increases. In short, this is big news in the banking biz. Although the U.S. Congress has held several hearings on the Accord, press coverage here has been spotty.

Thus, let me start by outlining what the new rules do and how they came to be before suggesting a different approach to global capital standards.

These standards are called the Basel rules because all the work on them comes under the aegis of the Basel Committee on Banking Supervision, a group housed at the Bank for International Settlements in – you're right – Basel, Switzerland. Basel I was finalized in 1988 after the Federal Reserve and Bank of England became deeply concerned that Japanese capital standards were permitting Japanese banks to become behemoths balanced on the heads of very tiny capital pins. The Basel I rules established very simple principles for bank risk-based capital – that is, how much shareholder equity and other holdings must back up loans and other assets based on the risk the assets present. Holdings in, say, Treasury obligations carry a 0% risk-based capital (RBC) charge under Basel I, while commercial loans (for example) must be backed by at least $8 for every $100.

Basel I was a big improvement over what went before – nothing – but it never led to the level playing field it intended. Although RBC standards did become more uniform, national discretion left gaping holes in nominal transnational compliance. Japan, for example, year-in and year-out said its banks met Basel I despite mounting problems that led all objective analysts to conclude that the banks were well below Basel over the last ten years or so.

Undeterred by the incomplete application of Basel I, global regulators have crafted Basel II because the first approach has only four risk categories. Risk, of course, is far more complex, and lumping everything from an AAA-rated corporate bond to total junk subprime loans to bankrupt borrowers in the Basel I top category has led to much "capital arbitrage" – that is, to banks exploiting differences between regulatory and economic capital. Basel II is supposed to shut this down by better aligning regulatory and economic capital. While they were at it, the Basel regulators decided not only to rewrite RBC ("Pillar 1 in the new Basel Accord), but also add global supervisory standards (Pillar 2) and – undaunted – new disclosure openings (???) as well (Pillar 3).

As noted, the Basel II Accord is very complex, but its reach is profound. Regulatory capital is a critical driver of business decisions. Banks get in or out of business lines – holding all other factors even – based on regulatory capital. When it's lower than economic capital, banks have a big market advantage; when it's higher, they have a concomitant disadvantage and exit the business line. Franchise decisions are also made – again, holding other factors even – based on regulatory capital. The fact that the Federal Reserve's capital standards apply at the parent company level is a major reason why almost no non-banks opted to become financial holding companies after Congress thought in 1999 that it had struck down all the barriers to financial-sector integration.

How Transnational Gets Tricky

How Basel II is implemented will have major competitiveness implications on banks versus non-banks, U.S. financial companies versus EU ones and big U.S. banks versus

small ones. Most of these competitiveness disparities would not occur if Basel II as a transnational rule were applied in the same way on the same institutions everywhere – the point, after all, of transnational regulations. However, let me now turn to some of the problems implementing Basel II based on national discretion and differences as to why a top-down approach is extremely difficult. I think, as I said, that more modest, principles-based standards have a better chance of avoiding the problems Basel II is already encountering – encountering, let me add, before the rule is even final in the U.S. and EU.