The U.S. Bet on Basel:
A Reconsideration of the Commitment to Global Financial Regulation

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Some weeks ago, the *American Banker* ran a lengthy article sparked by my suggestion that the U.S. should re-evaluate its commitment to coordinating bank regulation with the Basel Committee. One might have thought I urged the U.S. to pull out of the IMF, World Bank, NATO UN and even the Global Tiddlywinks League for all the fuss that greeted this thought. In fact, I don't advocate that the U.S. pull out of the global financial pow-wows – I'm an internationalist at heart – just that we think carefully about the degree to which U.S. and, indeed, global financial markets are put at risk because complex negotiations drag on and on and on even as financial markets shudder, shake and – now – stand again at the precipice. Some rules are done, to deservedly mixed reviews, but many more totally obvious reforms – especially with regard to too big to fail – remain untouched beyond talk except where, in the U.S., Dodd-Frank has settled the issue.

In many of the Basel rules, the U.S. has given on key issues to achieve compromises that, even then are implemented, if at all, in name only outside the U.S. Although U.S. participation in these global negotiations is premised on the worthy ideal of international cooperation, it is a lose-lose proposition for the United States, and, indeed, for the global financial system because needed reforms may seem to be in place but, in fact, are incomplete or unenforced. Let's recognize frankly that Basel takes too long and compromises too much. The U.S. should first work hard to fix it without giving ground on critical issues. If that can't be done, we should then make the hard decision to go it alone.

The League of Bank Regulators

The Basel Committee on Banking Supervision grew from the combination of hope and need that inspires other supranational bodies. In the mid-1980s, the U.S. and U.K. became deeply concerned that Japanese banks – operating then without any capital constraint – were gobbling up banks, buildings and everything else in their voracious path. The hope they had was that global pressure would bring the Japanese to heel to meet the need for the proverbial level playing field on bank regulatory capital. Thus was born the Basel Committee and, then, the global capital standards adopted in 1988 that came to be called Basel I.

Although a signal achievement, the Basel I Accord was also a flawed one. As I and several of you here thought at the time, it had some dangerous compromises. These included viewing all but sovereign, semi-sovereign and mortgage assets as having the same, moderate amount of credit risk. On day one of Basel I, we knew that a secured loan to a cash-risk corporate wasn't as risky as a high-flying one to a consumer who had gone bankrupt a time or two. But, Basel I liked them each just as much, creating a strong incentive for banks to maximize return by gaming risk-based capital. Basel I also ducked

the thorny question of off-balance sheet assets by ignoring them if maturities were less than a year. From that, the 364-day letter of credit quickly sprang.

Over time, the cracks in Basel I became clear because the ability of banks to arbitrage them grew impossible even for skittish supervisors to ignore. Thus, twelve years after Basel I came Basel II – regulators don't move fast. Because Basel II was tougher than Basel I and harder to implement – it was heavily models-dependent – regulators not only took their time finalizing the rule, but also implementing it. As a result, it was twenty years until almost the day after Basel I that Basel II's advanced options were actually in place. Like clockwork – and not entirely coincidentally – the financial crisis then took off, including among its casualties the Basel II capital rules.

The Current Basel Framework

Energized and chastened by the crisis, the Basel Committee acted with unprecedented alacrity. It finalized Basel III in only two years, adding to the global capital rules a liquidity one for good measure. And, unsatiated, the Basel Committee topped the new capital rules with a proposal last month for a surcharge for "global systemically-important banks" or G-SIBs.

Time doesn't permit a detailed discussion of any of these rules, which are of course mega ones with far-reaching competitiveness and market implications. What I'd like to do during the time I have left is to highlight aspects of the emerging Basel III framework that are not only at odds with what I think of as best practice for balanced, sensible regulation, but also being applied in delayed, inconsistent and – sometimes – even dangerous ways.

100% Saturated Regulation

The biggest problem I see with the Basel process is the dangerous nexus between a growing pile of over-ambitious, far-reaching rules and the inconsistent, uncertain and off-again/on-again way they are being implemented in major markets. Let me give you a few examples:

- **False Science**: The Basel rulebook is replete with complex rules comprised of convoluted formulas that, upon careful review, make a lot less sense than an awed reader might first conclude. A clear case is the Basel III liquidity rules. They are a ratio-driven hundred –plus pages based principally on regulatory best guess, not market experience under stress or validated supervisory practice.

- **Best Guesses are Not So Hot**: That regulators are doing their best is nice, but their best isn't always all that good. Both the liquidity and capital rules contain several axiomatic premises that simply don't make sense. It's not that we didn't know before the current debacle that sovereign debt is risky, but regulators still decided to pat their own governments on the back and treat it

as riskless. Even now, all the rules assume Greek debt is gold. Finalizing this regime will entrench this requirement, leaving a dangerous incentive untouched.

- **Logical Conflicts**: Even if each of the rules made sense on its own, the pile of them taken in concert doesn't. Case in point – compare the G-SIB surcharge, which is premised on the view that systemic banks will be rescued by taxpayers – with the U.S. and Financial Stability Board efforts to end too big to fail. One could argue that these disciplined resolution regimes are imperfect, but does it then make sense to double-tax G-SIBs – once for being seemingly TBTF and, then, for the loss of the safety net? Regulators should pick one – preferably an end to TBTF – not try to cut big banks off at both the knees and nose.

- **Bank-Centric Standards**: So far, all the rules I've talked about are what I call bank-centric. The non-bank system – often called shadow banking – isn't risk-free, as we of course learned at cost during the crisis. But, regulators continue their bank-centric focus because the global process doesn't permit agreement on the shadow sector. In fact, as an FSB paper earlier this month indicated, the only tentative agreement so far on shadow firms is to add yet another surcharge on banks that do business with them. Direct, meaningful action on non-bank systemic risk – e.g., in the MMF sector – gets lots of talk, but no action three years to about the day when non-banks like Lehman, AIG, Reserve Primary Fund and Fannie and Freddie kicked all this off. The bigger the pile of rules on banks – and the Basel pile is very, very big – the stronger the incentives for financial activity to arbitrage its way out of the regulator's clutches, sowing the seeds for the next systemic crisis even as banks are hobbled in their ability to perform their core credit-intermediation function.

Is Basel Really That Bad?

So far, I've listed a litany of problems with the Basel process – delay, confusion, conflict and relentless concentration on banks at the expense of other real risks. Are there good reasons for the U.S. to keep its seat at the Basel table?

Yes, if Basel bucks up. The initial wants and needs that spawned the Basel Committee and the slew of global structures that follow it remain.

Consistency across borders is indeed warranted, since inconsistencies cause competitiveness problems for well-regulated financial institutions and promote arbitrage to haven states and shadow banks. If Basel really did lead not just by hoped-for example, but also by actual issuance of standards that are consistently implemented, it would both simplify global financial regulation and improve it.

Cross-border rules aren't just a want because they're nice to have. They are also a need because, of course, financial institutions operate across national and market boundaries. Thus, when a cross-border firm falters, it puts at risk multiple financial markets and economies.

Knowing who is to pick up which pieces how – especially by ensuring that the who here is never, ever the taxpayer – would go a long way to stabilizing global finance without the cost of all the other complex rules I've touched on today.

Finally, the Basel Committee's roots – forcing recalcitrant regulatory regimes to heel – remain a real want and need. In recent years, the Committee has expanded in concert with the G-20 so that, now, critical emerging markets – China and India, for example – sit at the table. So far, I think the new players sign a lot they never intend actually to implement. But, if Basel can bring them not just to the table, but then actually make them eat, that will further the important cross-border causes of consistency and coherence.

For all the hope on which it was founded and the still-unmet need for global consistency, the Basel process is, I fear, falling far short of its goals. We shouldn't add more talk to all that under way on financial regulation, putting the should-we/shouldn't-we Basel question on the agenda for some action some time. While I think it's premature to conclude the U.S. should pull out of Basel, it's past time to take a hard look at the process to see if its purpose is in fact being met. If not, the U.S. should take the lead in ending deliberations that distract from real global action and go it alone to craft a meaningful, reformed regulatory framework for this nation now.