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The Great Recession and the Future of International Banking Cooperation

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Abstract:

The credit crisis of 2008 will likely produce reforms of the financial regulatory structure in the U.S., rearranging powers between regulators, implementing new rules governing the sort of risk financial institutions may assume, and instituting new consumer-oriented protections. The crisis made it clear that transparency and coordination of our regulation is crucial to the wellbeing of the U.S. economy. It follows that we should reexamine our coordination on the international level, as the world grows more, not less, interconnected. The current international standards for financial institutions set out in the Basel II Framework have proven to be ineffective, and the Committee on Banking Supervision should reexamine the requirements to make coordination worth the effort. While the Committee need not replace national discretion on bank risk, it should set out a common structure in which national regulators can implement standards that make sense for each respective nation. Necessary reforms include improved definitions of capital and financial instruments, less flexible capital requirements based on institution type, and real international accounting standards.

Since the credit crisis of 2008 became the liquidity crisis of 2009, the discussion of reforming banking oversight, both domestically and internationally, has reached the mainstream. As of April 2010, the House bill has passed and the Senate bill is currently on the floor. The bills agree in the need to reform the banking supervision and regulation system, originating from a White House plan to reform the system, but they take disparate approaches in finding a better way. The bill put forward in the Senate by Chris Dodd (D-CT) removes some of the bank

regulatory powers of the Federal Reserve (“Fed”), though it situates a new Consumer Protection Agency within the Fed.² Barney Frank’s bill in the House does just the opposite, leaving regulation of some state-chartered banks with the Fed, but situating the Consumer Protection Agency outside out the Fed.³ Both bills implement a number of other reforms specific to the U.S. regulatory structure.

The same debate has been occurring internationally. Globalization allowed a crisis that originated in the U.S. to spread internationally. If a breakdown in one market—in this case, the U.S. housing market—spreads across the globe, then recovery will likely be equally complicated. For example, Dubai, whose economy dramatically expanded over the past decade, particularly in real estate, has taken on enormous debts in an amount so large that stock markets around the world are beginning to stall.⁴ Kevin Grice, senior international economist at Capital Economics, noted that “Dubai is really a symptom, a legacy, from the previous boom, rather than symptomatic of a start of a whole new set of issues that are going to create a systemic crisis in emerging markets. Markets assume the worst-case scenario.”⁵ It seems, then, that some sort of international cooperation would increase the stability of a recovery in the same way as it might prevent a crisis in one isolated market from spreading into other markets, of type and geography. This is what the Basel Capital Accord tries to accomplish.

I. Introduction

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³ Liberto, supra note 1.
⁵ *Id.*

Lord Turner echoed concerns that globalization causes market crises to spread, but he notes that decisions about standards and extension of credit on individual bases are on a domestic level. This means that if these crises need to be addressed internationally, then the solution needs to target domestic decision-making processes.

Lord Turner stated that the present crisis in the Chinese property market, for instance, has to do more with the “dynamism of underlying demand” rather than any inflated result of the crash in the developed world, or a bubble effect. In the developing world, though, he hypothesizes that bubbles might be forming, ones that could burst when the developed world is in recovery, and stall that recovery. To prevent the development of any bubbles in the developing world or any chronic instability in nations such as China or India, the developed world needs to coordinate its measures, so that any recovery that does occur develops similarly across borders and does not create any imbalances that develop into instability if the rate of recovery declines. This is where the Basel Committee and Framework step in.

As a note, this paper should be read within the context of the financial crisis as of May 5, 2010. The history and organization of the Bank for International Settlements (hereinafter “BIS”)

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7 *Id.*

8 *Id.*

9 *Id.*
only go up to this point, and any discussion of the implementation of Basel II, the second Basel Accord, and the future of a new Framework should be read within this limitation. Finally, the paper also includes some discussion on banking reform in the U.S., and it has currently been updated to May 5, 2010.

II. History of International Cooperation

A. Bank for International Settlement

1. Development

The first substantiation of international banking cooperation began just after the largest financial crisis ever, the Great Depression, broke out in the U.S.\(^\text{10}\) In 1930 the BIS was organized as a private commercial bank by a treaty signed in the Hague.\(^\text{11}\) It was part of the Young Plan, organized to collect and distribute payment of annuities as reparation (hence, “Settlement”) by Germany according to the Treaty of Versailles.\(^\text{12}\) The Bank was also charged to hold assets immune from governmental interference, and it was maintained by profits received from bank transactions without the need for fees.\(^\text{13}\) The U.S. initially did not formally participate in the BIS, but it did observe meetings.\(^\text{14}\)

After World War II, allegations arose that the Bank laundered money on behalf of Nazi Germany, something the U.S. used in attempting to move its monetary functions to the newly-created International Monetary Fund (hereinafter “IMF”), established at the Bretton Woods


\(^{11}\) *Id.*

\(^{12}\) BIS History – Overview, *http://www.bis.org/about/history.htm.*

\(^{13}\) Epstein, *supra* note 10.

\(^{14}\) *Id.*
Conference. The U.S. failed in derailing the BIS and instead ended up joining. As the bank evolved, it became a clearing house for currency swaps, most notably in U.S. Dollars, as well as gold, used to back up many national currencies. The BIS also began to manage a large number of mutual funds of short term investments, the placement of those funds remaining secret, used by many member nations. The Bank also intervened in a number of global financial crises, including the oil and international debt crises in the 1970s and 1980s. It has also functioned as intermediary in a number of cases, as both trustee and agent, for the European Payments Union between 1950 and 1958 and for the European Monetary System between 1979 and 1994.

In 1977, the BIS began to become more transparent, including a formal headquarters in Basel, Switzerland, where it had been meeting since its inception. At the same time, however, the Board of BIS has strengthened its monopoly on international monetary regulation, standing in the way of other institutions including the Organisation for Economic Co-operation and Development (“OECD”), from taking any action to coordinate national monetary policy. The Board, discussed in the next section, has been criticized in the past for operating like an old boys’ club, with tendency toward groupthink rather than engaging in vigorous debate about national interests. In the same way, the Board and the Bank have developed a tendency toward the pragmatic, rather than the ideological, though whenever any member is in need of the Bank’s

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15 Id.  
16 Id.  
17 Id.  
18 Id.  
20 Id.  
21 Epstein, supra note 10.  
22 Id.  
23 Id.
services, the BIS comes to its aid.\textsuperscript{24} Between 1931 and 1933, the BIS provided credit to the
governments of both Germany and Austria, while in the 1960s it provided support to currencies
such as the French Franc and British Pound Sterling.\textsuperscript{25} But the BIS’ support has gone not only to
developed nations but to less-developed nations as well: the Bank financed a number of IMF
stabilization programs, including for Mexico and Brazil.\textsuperscript{26}

2. Organization

The Bank’s functions result from the governance of three important bodies in the BIS, the
General Meeting of central bank members, the Board of Directors, and the Bank Management.\textsuperscript{27}
A number of statutes govern the internal workings and mission of the BIS, including the Hague
Convention, Constituent Charter, and the BIS Statutes.\textsuperscript{28} The Bank’s members now number fifty-
six.\textsuperscript{29} Shares are issued to member banks, and votes at the annual General Meetings are
proportionate to those shares.\textsuperscript{30} Matters presented to the General Meetings relate to dividing the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{24} Id.
\item \textsuperscript{25} BIS History – Overview, http://www.bis.org/about/history.htm.
\item \textsuperscript{26} Id.
\item \textsuperscript{27} Organisation and governance, http://www.bis.org/about/orggov.htm.
\item \textsuperscript{28} Legal information, http://www.bis.org/about/legal.htm.
\item \textsuperscript{29} Id. The following national central banks are members: Algeria, Argentina, Australia, Austria, Belén, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Macedonia (FYR), Malaysia, Mexico, the Netherlands, New Zealand, Norway, the Philippines, Poland, Portugal, Romania, Russia, Saudi Arabia, Serbia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Kingdom and the United States, plus the European Central Bank. Id.
\item \textsuperscript{30} Id.; The BIS in profile, http://www.bis.org/about/profile.htm.
\end{itemize}
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Bank’s profits and dividends, not on monetary policy.\textsuperscript{31} Decisions on monetary policy are handled internally, at the Board of Governors and Committee level.

The Board of Governors currently has nineteen members and is currently chaired, for a three-year term, by Guillermo Ortiz, Governor of the Bank of Mexico.\textsuperscript{32} The heads of the central banks of the United States, United Kingdom, France, Germany, Italy, and Belgium are automatically \textit{ex officio} members of the Board, each of whom is allowed to appoint one other member to the Board.\textsuperscript{33} Up to nine other members may be elected from the other central bank members.\textsuperscript{34} The Board of Governors is tasked with overseeing the responsibilities laid out in the Statutes, which include management of the bank as well as other policy matters.\textsuperscript{35} The Board thus works in four committees to accomplish those goals: the Administrative Committee, the Banking and Risk Management Committee, the Audit Committee, and the Nomination Committee.\textsuperscript{36}

3. Goals and Functions

\textsuperscript{31} Legal information, http://www.bis.org/about/legal.htm.
\textsuperscript{33} \textit{Id}.
\textsuperscript{34} \textit{Id}.
\textsuperscript{35} \textit{Id}.
\textsuperscript{36} \textit{Id}.
The BIS states its mandate is to “foster[] international monetary and financial cooperation and serve[] as a bank for central banks.” 37 It does so by “acting as a forum to promote discussion and policy analysis among central banks and within the international financial community, a centre for economic and monetary research, a prime counterparty for central banks in their financial transactions, [and as] agent or trustee in connection with international financial operations.” 38

In addition to its policy-making functions, the Bank helps central banks manage their foreign exchange reserves. 39 Private individuals or other banks cannot participate. 40 Total special drawing rights available to central banks amount to around $197 billion, about four percent of world foreign exchange reserves. 42 And as noted before, the bank also performs investment functions for its members to increase the return on central banks’ foreign assets. 43 The BIS creates both individual portfolios for members that so request and allows members to place assets in pools managed by BIS investors. 44 Finally, the Bank serves as a lender of last resort, but only on a short-term basis and usually in collateralized situations, and it holds collateral for government loans. 45

B. Basel Committee on Banking Supervision

38 Id.
40 Id.
41 Special drawing rights are international reserve assets, created by the International Monetary Fund, based on a “basket” of currencies, including the U.S. Dollar, Euro, Pound Sterling, and Yen. Special Drawing Rights, http://www.imf.org/external/np/exr/facts/sdr.htm.
42 The BIS in profile, http://www.bis.org/about/profile.htm.
43 Id.
44 Id.
45 Id.
1. Formation and Organization

The Committee on Banking Supervision is one of five committees of the Governors, who meet bi-monthly to implement monetary policy.\(^{46}\) Other committees include the Committee on the Global Financial System, which works to identify stresses in the global financial markets, and the Markets Committee, which discusses recent current events in the financial markets.\(^{47}\)

The Committee on Banking Regulations and Supervisory Practices, also known as the Basel Committee, was formed in 1974 after a number of banking and currency crises, most notably the failure of Bankhaus Herstatt in West Germany.\(^{48}\) Domestic regulators closed the bank on June 26, 1974, and a number of counterparties were left in the cold because their claims in foreign currency, particularly U.S. Dollars, were unsecured.\(^{49}\) Such settlement risk is now known as “Herstatt Risk.”\(^ {50}\)

The Committee on Banking Supervision is the forum that focuses on banking supervisory matters for the BIS.\(^ {51}\) The Committee also works to develop common standards from the shared approaches of its member nations.\(^ {52}\) Along with the International Convergence of Capital Measurement and Capital Standards and the the Basel Frameworks, the Committee is also responsible for the Core Principles for Effective Banking Supervision and the Concordat on

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\(^{50}\) Id.
\(^{52}\) Id. Committee members include Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The current Chairman is Nout Wellink, President of the Netherlands Bank. Id.
cross-border banking supervision. Every two years, it sponsors an International Conference on Banking Supervisors.

The Committee Secretariat, the permanent staff for the Committee, is located in Basel, Switzerland, headed by Stefan Walter, the Secretary General of the Committee. The Committee’s work is organized in four subcommittees, or groups: the Standards Implementation Group, the Policy Development Group, the Accounting Task Force Group, and the Basel Consultative Group. The Standards Implementation Group is charged with coordinating the sharing of information among members implementing the Basel II Framework, and the Policy Development Group assists the Committee in developing policies by filtering issues related to the implementation of the Framework. The Accounting Task Force works to develop policies that promote safe and consistent accounting practices. Finally, the Basel Consultative Group is the outreach function of the Committee, organizing dialogue with bank supervisors of non-member countries.

2. Basel I

Daniel K. Tarullo, a member of the Board of Governors of the Federal Reserve System, views the strengthening of the Basel arrangement into an agreement as the product of two rising concerns: “the risk posed to the stability of the global financial system by low capital levels of internationally active banks and the competitive advantages accruing to banks subject to lower

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53 Id.
54 Id.
55 Id.
56 Id.
57 Id.
58 Id.
capital levels.”\(^{59}\) Over time, individual Basel nations had developed regulations based on risk-based capital ratios, that is, evaluating the health of banks by certain ratios of assets.\(^{60}\) But despite this rise of similarly-constructed regulation, the increasing interconnectedness of the world’s financial systems meant that, according to Tarullo’s logic, banks operating in nations with more relaxed capital ratios were at a competitive advantage to raise and loan out money. It would follow that those banks could attract more business, taking it away from banks operating in countries with tighter capital regulation, and the risk to the international banking system as a whole would increase so long as those disparities existed. The only way to remove such disparities, and thus the ability to overleverage, that is, loaning out too high a percentage of the bank’s assets, would be to harmonize those capital ratio minimums. It becomes evident some form of an agreement was necessary.

Realistically, however, the only motivation behind this agreement, later termed “Basel I,” was not idealism (stabilizing the international banking system); it also had an element of realpolitik, to be most crude. The U.S. Congress, when authorizing the setting of domestic capital levels, as well as entering international harmonization discussions in 1983, was somewhat hesitant to actually raise minimum capital levels, imagining that the competitive advantage of U.S. banks over, for instance, those in some European countries, would be eliminated.\(^{61}\) Nevertheless the Federal Reserve took up the push to harmonize in 1984, when Chairman Paul Volcker made a presentation to the Basel Committee.\(^{62}\) Congress’ fear of the U.S. losing its competitive advantage were allayed as the 1980s marched on as it became evident that the U.S.

\(^{60}\) Id. at 45.
\(^{61}\) Id.
\(^{62}\) Id. at 50.
was not at a competitive advantage in an era of un-harmonized banking regulations, but at a
disadvantage, as Japan had grown from having one of the top ten international banks in assets in

As Japanese banks began to rise in the listing of largest world banks, it became evident that, although a lower capital ratio did not necessarily translate into a higher position on the chart, lowering the capital ratio resulted in a shift up the chart.  

So while the history of the Basel negotiations is much more complicated, U.S. hesitations withered away, and as Europe and the U.S. went, so did the rest of Basel member nations.

After reaching limited agreements with both the United Kingdom and Japan, the U.S. pushed Basel to begin formal negotiations on harmonized standards in 1987.  

Major points of contention included what to include in “capital,” specifically what sort of loan loss reserves would be counted in the ratio.  

Though the groundwork of what would become the “Framework” had begun in 1982, it was these negotiations that brought it to life.  


The Basel Capital Accord, or the International Convergence of Capital Measurement and Capital Standards, was completed in July 1988, agreed to by the central bank heads of the

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63 *Id.* at 46. This dramatic shift held true when considering total assets as well: of the world’s top twenty banks, Japanese banks held just more than a quarter of the total assets of those banks in 1981, while in 1988, that percentage had grown to over seventy percent. *Id.*
64 *Id.* at 48.
65 *Id.* at 50-51.
66 *Id.* at 51.
67 *Id.* at 53.
68 *Id.* at 55.
Group of 10 nations.\textsuperscript{70} The job then was to implement the standards and requirements set in the Framework, as domestic regulations required changes to conform to the Framework.\textsuperscript{71}

Basel I set out two objectives,

that the new framework should serve to strengthen the soundness and stability of the international banking system; and . . . that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks.\textsuperscript{72}

And in its introduction, the Framework made a few important points. First, the standards to which the Framework agreed are minimums, and domestic lawmakers and regulators are free to set higher minimums.\textsuperscript{73} Second, there are areas intentionally left outside the agreement, about which domestic lawmakers and regulators are free, but not required, to set standards; for example, the Framework only analyzes assets according to credit risk, not other risks.\textsuperscript{74} In fact, even within the Framework, there are places in which express discretion is given to nations.\textsuperscript{75} Finally, the Framework notes that while its standards are intended to apply to all financial institutions, including banks, holding companies, and subsidiaries, there may be particular structures that are out of reach of the Framework and national regulators.\textsuperscript{76} To reach the eight percent minimum, banks would add up their total capital, or “capital base,” consisting of Tier 1 and Tier 2 capital, the former being equal to or greater than the latter.\textsuperscript{77} Tier 1 and 2 will be defined later.

Two pieces of Basel I stand as evidence of its lasting impact, even when considering the

\textsuperscript{70} Id. ¶ 1.  
\textsuperscript{71} TARULLO, supra note 59, at 52.  
\textsuperscript{72} Basel I, supra note 69, ¶ 3.  
\textsuperscript{73} Id. ¶ 7.  
\textsuperscript{74} Id. ¶ 8.  
\textsuperscript{75} Id. ¶ 6.  
\textsuperscript{76} Id. ¶ 10.  
\textsuperscript{77} Id.
subsequent changes Basel II made. Those pieces are the framework’s standards of capital adequacy, or “[t]he constituents of capital,” as well as classification of credit risk, or “[t]he risk weights.” The Committee solved the controversy surrounding the definition of capital by creating two categories, which resulted in two ratios against which all weighted risk assets or off-balance-sheet items of various credit risk categories weighted using conversion factors would be compared. The Framework set the overall capital to weighted risk assets minimum at eight percent, with “core” capital being set at a minimum of four percent against weighted risk assets.

a. Capital adequacy standards

In order reach a consensus about what constitutes “capital,” the Committee decided to divide the definition into two tiers: Tier 1 being “core” capital and Tier 2 being “supplementary” capital. The Basel I Framework sets Tier 1 capital to include both permanent shareholders’ equity and disclosed reserves. Thus, core capital includes most shareholder equity, plus reserves created by earnings or other profit measures, as well as any other general funds that satisfy the following requirements:

• allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential tax liabilities;
• the funds and movements into or out of them must be disclosed separately in the bank’s published accounts;
• the funds must be available to a bank to meet losses for unrestricted and immediate use as soon as they occur;

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78 Basel I, supra note 69.
79 TARULLO, supra note 59, at 55-56.
80 Basel I, supra note 69, ¶ 44.
81 Id. ¶ 14.
82 Id. annex 1.
• losses cannot be charged directly to the funds but must be taken through the profit and loss account.\textsuperscript{83}

General funds that meet these requirements are intended to be as available to the bank as any other profit. Bowing to pressure from the U.S., the Committee relented to including noncumulative perpetual preferred stock in the category of permanent shareholder equity, allowing more flexibility to issuing preferred stock.\textsuperscript{84} The Framework views Tier 1 capital funds as the most critical to the continued operation of the bank.

Tier 2 capital, on the other hand, includes funds that not as available and publicly known as Tier 1. Annex 1 lists five categories of Tier 2 capital: undisclosed reserves, asset revaluation reserves, general provisions/general loan-loss reserves, hybrid (debt-equity) capital instruments, and subordinated debt.\textsuperscript{85} Undisclosed reserves would include any post-tax reserves kept off-balance-sheet, if the country allows it.\textsuperscript{86} Revaluation reserves include, for example, assets resulting from legally authorized revaluations, often of real estate.\textsuperscript{87} They also included unrealized gains on outstanding securities, an inclusion particularly important for Japan, though the entire category was valued only at 45\% of face.\textsuperscript{88} General provisions or loan-loss reserves are held to make up for loan and other losses that arise during the running of the bank.\textsuperscript{89} Hybrid (debt-equity) capital instruments include characteristics of both equity capital and debt, and satisfy the following criteria:

• they are unsecured, subordinated and fully paid-up;

\textsuperscript{83}\textit{Id.}  
\textsuperscript{84} TARULLO, supra note 59, at 56.  
\textsuperscript{85} Basel I, supra note 69, annex 1.  
\textsuperscript{86}\textit{Id.}  
\textsuperscript{87}\textit{Id.}  
\textsuperscript{88} TARULLO, supra note 59, at 56.  
\textsuperscript{89} Basel I, supra note 69, annex 1.
• they are *not redeemable* at the initiative of the holder or without the prior consent of the supervisory authority;
• they are *available to participate in losses* without the bank being obliged to cease trading (unlike conventional subordinated debt);
• although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders’ equity), *it should allow service obligations to be deferred* (as with cumulative preference shares) where the profitability of the bank would not support payment (original emphasis). \(^9\)

The category is intended to include a number of specific subordinated and convertible instruments in individual Basel countries. Finally, subordinated term debt is included in Tier 2 capital if the debt has a maturity of at least five years and “limited life redeemable preference shares.” \(^9\) However, during the last five years to maturity, a cumulative discount rate of 20\% is applied. \(^9\) But in order to limit the amount of Tier 2 capital in the form of subordinated term debt, the Framework prescribes it not to exceed 50\% of Tier 1 capital, which is set to be at least equal to total Tier 2. \(^9\)

b. Credit risk classification

On the other side of the equation, the Framework sets out various percentage weights to be applied to both assets (on-the-balance sheet) and off-the-balance sheet items to account for credit risk. Bigger weights are applied to riskier assets, thus requiring a compensating increase of capital on the other side of the equation to maintain the total capital and Tier 1 capital minimums. These weights are intended to make comparison between various banking systems easy, to include off-balance-sheet funds into the risk calculation, and not to dissuade banks from

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\(^9\) Id.
\(^9\) Id.
\(^9\) Id.
\(^9\) Id.
holding liquid assets such as cash.\textsuperscript{94} They are determined based on the “generic nature” of the borrower, the counterparty to the bank, rather than the specific borrower.\textsuperscript{95}

The general structure of the weights is as follows. For assets on the balance sheet, liquid assets that carry little or no risk are valued at zero percent and thus require no compensating capital, including cash, claims on central governments and central banks, or claims on other OECD central governments and central banks or public sector entities if guaranteed or collateralized by those entities.\textsuperscript{96} On the other end of the spectrum, receiving a valuation of 100\%, are the riskiest assets held by banks, including claims on the private sector, claims on non-OECD banks having a residual maturity of over one year, claims on non-OECD central governments, real estate, and any assets not included in other categories.\textsuperscript{97} Thus, if any new instruments were to be created and were not categorizable by Basel I, they would be considered under a worst-case scenario and given the lower discount.\textsuperscript{98} In the middle category, at fifty percent, are loans secured by a residential mortgage if the home is or will be occupied by the borrower.\textsuperscript{99} At twenty percent are claims on development banks guaranteed by the banks or collateralized, claims on banks incorporated in the OECD, claims on banks outside the OECD having a residual maturity of at least one year and guaranteed by banks in the OECD as well as claims on non-domestic OECD public sector entities.\textsuperscript{100} Finally, domestic regulators are given discretion on one category, valuing at either zero, ten, twenty, or fifty percent, claims on

\textsuperscript{94} Id. ¶ 28.  
\textsuperscript{95} TARULLO, supra note 59, at 57.  
\textsuperscript{96} Basel I, supra note 69, annex 2.  
\textsuperscript{97} Id.  
\textsuperscript{98} Id.  
\textsuperscript{99} Id.  
\textsuperscript{100} Id.
domestic public sector entities excluding the central government as well as loans secured by those entities.\textsuperscript{101}

But Basel I incorporated items that are allowed to remain off-balance-sheet. Since such items are not on a bank’s balance sheet, they do not pose any imminent credit risk, but the possibility remains that circumstances could move them on-balance-sheet.\textsuperscript{102} Thus, a conversion factor would be applied to various items, estimating the likelihood that such items would be moved on-balance-sheet.\textsuperscript{103} At that point, the conversion factor would be multiplied by what would be the asset equivalent, as set out in the previous paragraph, then added to asset side of the capital ratio.\textsuperscript{104} Items getting a 100\% conversion factor, which would indicate a high likelihood of such items being moved on-balance-sheet, include direct credit substitutes (for example, standby letters of credit), certain sale and repurchase agreements, and forward asset purchases and deposits.\textsuperscript{105} On the other end of the spectrum, off-balance-sheet commitments with a maturity of less than one year that are able to be unconditionally cancelled are given a zero percent conversion factor, thus eliminating them from inclusion in the final asset total, since they pose a marginal potential for credit risk.\textsuperscript{106} At fifty percent, banks are to include formal standby credit lines, issuance and underwriting facilities, and certain transaction-related contingent items.\textsuperscript{107} And at twenty percent, Basel II mandates factoring short-term self-liquidating trade-

\textsuperscript{101} \textit{Id.}
\textsuperscript{102} TARULLO, supra note 59, at 59.\textsuperscript{103} \textit{Id.}\textsuperscript{104} \textit{Id.}\textsuperscript{105} Basel I, supra note 69, annex 3.\textsuperscript{106} \textit{Id.}\textsuperscript{107} \textit{Id.}
related contingencies, or certain credits in international trade situations collateralized by the shipment being processed.\textsuperscript{108}

Tarullo assesses the success of Basel I based on “whether the arrangement has been implemented and observed by states in accordance with its terms” as well as “whether the arrangement, as implemented, has been effective in achieving its stated ends.”\textsuperscript{109} On the first question, Tarullo said Basel I was successfully implemented, but on the second question, a number of issues arose that demanded, most notably, the creation of the advanced internal ratings-based approach for evaluating credit risk.\textsuperscript{110} The Basel I measurement, then, was not necessarily too restrictive in terms of allowing reasonable risk, but it did not accurately target risk, especially considering the increasing complexity of financial instruments, and thus encouraged effective risk management on the part of banks, who were lulled into thinking the Framework adequately evaluated risk.\textsuperscript{111} Additionally, the Framework seems to have not discouraged the pro-cyclicality of the credit market; as capital begins to dry up, banks are forced to stop lending, which diminishes the capital of other entities as well as their ability to lend.\textsuperscript{112} The inflexibility of the capital ratios in an economic downturn makes recessions deeper, because there is a point at which lenders are not allowed to take marginal risk.\textsuperscript{113} Finally, concerns also begin to rise as to whether risk was appropriately accounted for in the weights assigned to on-balance-sheet assets.\textsuperscript{114} If they were too flexible, the Framework was unnecessarily encouraging

\begin{flushleft}
\textsuperscript{108} Id.
\textsuperscript{109} TARULLO, supra note 59, at 64.
\textsuperscript{110} Id. at 64-65.
\textsuperscript{111} Id. at 83.
\textsuperscript{112} Id. at 78.
\textsuperscript{113} Id.
\textsuperscript{114} Id.
\end{flushleft}
potentially dangerous securitization, but if they were too tight, the Framework was discouraging innovation in the form of financial instrumentation.\textsuperscript{115}

III. Basel II

Basel II was intended to be a more complete “measure and minimum standard for capital adequacy.”\textsuperscript{116} After Basel I, the second Framework was intended to better coordinate regulatory capital requirements to underlying risk as well as to encourage a more future-looking approach by national regulators.\textsuperscript{117} In that way, banks could better identify individual risks before they turn into crises.\textsuperscript{118} It had become evident that viewing bank risk through the sole lens of credit risk was no longer sufficient—the rise in mechanisms such as securitization meant that simple credit risk, especially when based purely on the general nature of the counterparty, did not adequately predict bank health.\textsuperscript{119} In comparison to Basel I, Basel II was written to allow for more flexibility for regulators and banks as external market conditions change.\textsuperscript{120} Tarullo states that Basel II was significant in two ways: first, it overhauled the agreed-to minimum capital standards, which stand as the basis for global financial regulation, and second, it raised the level of cooperation to new levels not yet achieved.\textsuperscript{121}

A. Negotiation and Overview

\begin{footnotes}
\item[115] \textit{Id.} at 82-83.
\item[117] \textit{Id.}
\item[118] \textit{Id.}
\item[119] TARULLO, \textit{supra} note 59, at 88.
\item[121] TARULLO, \textit{supra} note 59, at 1.
\end{footnotes}
Criticisms of Basel I resulted in a proposal for a new Framework beginning in 1996, even before Basel I amendments had ceased.\textsuperscript{122} That December, it became known that the Fed was considering much bigger change to the arrangement than had previously been contemplated.\textsuperscript{123} Within two years, central bank members had begun to meet not only to discuss problems with Basel I but also ways to fix it.\textsuperscript{124} From the winter of 1998 to the fall of 1999, discussions had evolved into a plan to publish a consultative paper to create a basis for a new Framework.\textsuperscript{125} The paper, when released, did not propose the sort of dramatic changes that observers thought would be likely but simply restructured the Basel I arrangement under what it termed a “three-pillar” approach.\textsuperscript{126} That approach remained in the final Basel II Framework.\textsuperscript{127} Before the final Framework was released in 2004, two more consultative papers had been released, and slowly a number of reforms were developed.\textsuperscript{128} Those reforms will be discussed at length below. Although the Committee has continued to adopt revisions to Basel II through July 2009, the main features noted below are from June 2006, when the last major revisions were released, at which point the Committee released a “Comprehensive Version” of Basel II.\textsuperscript{129}

The Framework sets out a number of ways it is intended to better protect the international banking system than Basel I did. First, the Committee attempted to structure the capital

\textsuperscript{122} \textit{Id.} at 89.  
\textsuperscript{123} \textit{Id.}  
\textsuperscript{124} \textit{Id.}  
\textsuperscript{125} \textit{Id.}  
\textsuperscript{126} \textit{Id.}  
\textsuperscript{128} TARULLO, \textit{supra} note 59, at 121-22.  
\textsuperscript{129} Basel II, \textit{supra} note 127.
requirements to be more risk-sensitive than Basel I provided.\textsuperscript{130} Second, the actual risk determinations are intended to be better-coordinated with internal bank risk management evaluations, a revision that is intended to better manage risk as well as to not interfere with internal risk management.\textsuperscript{131} And a number of Basel I’s structures remain: there are areas of national discretion, the capital requirements are intended to be minimums only, and national lawmakers and regulators have to implement the Framework.\textsuperscript{132}

B. Three Pillars

1. Minimum Capital Requirements

   a. Credit Risk

The first of the three pillars of the Basel II Framework is Minimum Capital Requirements. Just as with Basel I, total capital must be at least eight percent of risk-weighted assets, with Tier 2 capital being no more than Tier 1 capital, according to their definitions.\textsuperscript{133} The basic definitions of Tier 1 and 2 capital remain the same as in Basel I,\textsuperscript{134} with the general provisions/loan-loss reserves category of Tier 2 capital subject to a few modifications, primarily that they are limited to 1.25% of risk-weighted assets.\textsuperscript{135} Tier 1 capital remains primarily equity capital and disclosed reserves.\textsuperscript{136} The Framework does spell out critical deductions from capital, as such funds are not fully available to the bank if needed, including goodwill, an increase in

\textsuperscript{130} Id. ¶ 5.
\textsuperscript{131} Id. ¶ 6.
\textsuperscript{132} Id. ¶¶ 2, 7, 9.
\textsuperscript{133} Id. ¶ 40.
\textsuperscript{134} Id. annex 1a.
\textsuperscript{135} Id. ¶ 42.
\textsuperscript{136} Id. ¶ 49(i).
equity capital resulting from a securitization exposure (see next section), and investments in unconsolidated subsidiaries,\(^{137}\) leaving the possible deduction of capital holdings of external financial institutions to the discretion of national regulators.\(^{138}\)

Such capital is compared against risk-weighted assets. One of the biggest reforms of Basel II is the choice presented to national regulators to determine credit risk, either by the Standardized Approach or the Internal-Ratings Based (“IRB”) Approach.\(^{139}\) The Standardized Approach rates credit risk based on external credit assessments, while the IRB Approach, if approved by national regulators, depends on internal bank risk evaluation systems.\(^{140}\) The Standardized Approach is an expansion of the Basel I credit risk approach, but different asset types are broken down differently and often given different weights according to their credit rating.\(^{141}\) Off-balance-sheet items are given conversion factors similar to those in Basel I.\(^{142}\) Assets are individual claims and include including claims on sovereigns, public sector entities, banks, securities firms as well as other corporates.\(^{143}\)

The IRB Approach, or Foundational IRB Approach, on the other hand, allows banks, if given the clear by their national regulator, to use their internal risk assessment mechanisms to weight assets.\(^{144}\) Under the IRB approach, exposures are categorized as either measures of unexpected loss (“UL”) or expected loss (“EL”).\(^{145}\) The UL portion is given risk-weights to

\(^{137}\) *Id.* ¶ 49(xv).
\(^{138}\) *Id.* ¶ 49(xv).
\(^{139}\) *Id.* ¶ 50-51.
\(^{140}\) *Id.*
\(^{141}\) *Id.* ¶ 52.
\(^{142}\) *Id.* ¶ 82.
\(^{143}\) *Id.* ¶ 53-81.
\(^{144}\) *Id.* ¶ 211.
\(^{145}\) *Id.* ¶ 212.
evaluate the capital requirements. There, assets are divided into five classes, including corporate, sovereign, bank, retail, and equity. The Framework then sets out category-specific rules by which credit risk must be evaluated for assets in each category. Those rules include the type of information that should be used to estimate credit risk, formulas by which credit risk is calculated as well as minimum requirements for bank risk evaluations. And finally, there are minimums for eligibility of using the IRB approach. It is the bank’s burden to demonstrate to its appropriate regulator that it is eligible to use the IRB approach.

There are two variations of the IRB Approach, called the Foundational IRB Approach and the Advanced IRB Approaches (“A-IRB”), the latter being one of the important innovations in Basel II. Using either IRB Approach requires banks to estimate the probability of default (“PD”) of a particular asset in order to plug the asset into the minimum capital requirements. A bank may choose to follow certain parameters enforced by supervisors for three other factors, or it may estimate these factors internally, subject to certain minimums set by the Framework. The Foundational Approach would have banks rely on supervisory parameters for estimating the loss of a given default (“LGD”), the exposure at default (“EAD”), along with a calculation of the effective maturity (“M”) of that asset, while the A-IRB approach would allow banks to estimate or calculate these numbers internally. The tradeoff for being able to use the A-IRB approach is

146 Id. The EL portion, on the other hand, is used to evaluate the eligible amount of general provisions to be included in Tier 2 capital. General provisions can be included up to the amount of expected losses, thus allowing banks to set aside as capital provisions for expected losses that they have quantified, but no more. Id. ¶ 43.
147 Id. ¶ 215.
148 Id. ¶ 270-361.
149 Id. ¶ 244.
150 Id. ¶ 387.
151 Id. ¶ 388.
152 Id. ¶ 245.
153 Id.
154 Id.
agreeing to be subject to parallel calculations for a period along with impact studies on the effectiveness of the internal estimates and calculations. This is presumably to make sure that the bank is properly calculating its ratios and to make sure that the estimates that are calculated are effective in determining risk.

b. Operational Risk

Calculations of operational risk and market risk are added to the risk-weighted assets for credit risk calculation discussed above to add up to the total risk-weighted assets, the number compared against the capital calculations. The inclusions are a major reform of Basel II so that total risk is fully considered. Operational risk is defined as “the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.” It can be calculated by three different approaches: the Basic Indicator Approach, the Standardized Approach, or the Advanced Measurements Approach. The Basic Indicator Approach requires consideration of a flat percentage of the bank’s gross revenue, while the Standardized Approach varies the percentage, but considers different lines of business of the bank. The Advanced Measurements Approach is different, allowing the risk to be calculated by internal measurements subject to certain requirements.

c. Market Risk

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155 Id. ¶ 263.
156 Id. ¶ 44.
157 Id. ¶ 644.
158 Id. ¶ 645.
159 TARULLO, supra note 59, at 125.
The Market Risk inclusion in risk-weighted total assets is a holdover from a 1996 amendment to Basel I.\textsuperscript{160} Market Risk is defined as “the risk of losses in on and off-balance-sheet positions arising from movements in market prices.”\textsuperscript{161} Such risk includes both interest rate risk and foreign exchange rate risk.\textsuperscript{162} Market Risk is calculated by methods similar to the Operational Risk process, including the Standardized Measurement Method and the Internal Models Method, the former relying upon standards set out in the Framework and the latter depending on eligible internal calculators.\textsuperscript{163}

2. Supervisory Review Process

The second pillar relates to the Supervisory Review Process. This pillar, along with the third, is a creation of Basel II and does not elaborate on the capital minimum. The pillar sets out requirements relating to, among other things, the treatment of interest rates on bank books, the booking of various risks, and securitization.\textsuperscript{164} The Framework sets out four principles relating to supervisory review. They are as follows:

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels . . . Principle 2: Supervisors should review and evaluate banks’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process . . . Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks

\textsuperscript{160} Basel II, \textit{supra} note 127, ¶ 5.
\textsuperscript{161} \textit{Id.} ¶ 683(i).
\textsuperscript{162} \textit{Id.}
\textsuperscript{163} \textit{Id.} ¶ 709-18.
\textsuperscript{164} \textit{Id.} ¶ 719.
to hold capital in excess of the minimum . . . Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.\textsuperscript{165}

3. Market Discipline

Finally, Basel II sets out certain requirements relating to market discipline. The idea is to create disclosure requirements to “allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.”\textsuperscript{166} The section goes on to list a number of disclosures required of all banks. Such disclosures are intended to inform the market about appropriate risks, effectively closing the information loop back to the first pillar.

IV. The Credit Crisis and the Future

A. Nature of the Crisis

By most measures the financial crisis of 2008-2009 was the most disrupting event in international finance since the onset of the Great Depression. The credit crisis of 2008 resulted from the overextension of credit in multiple finance markets.\textsuperscript{167} It was precipitated by a series of defaults in the subprime mortgage market, which spread to the housing market as a whole as well as other finance and labor markets. The effects still linger in 2010 and will likely continue to do so for years, especially considering the possibility that the U.S. and global economies may not

\textsuperscript{165} Id. ¶¶ 726, 746, 757, 759.
\textsuperscript{166} Id. ¶ 809.
\textsuperscript{167} Id. at 92.
recover to pre-2008 levels before the market cycles through its expansion period. The period, from 2008 to a date unknown in the future, may then be known as the Great Recession. If anything, the Recession has disproven any remaining contention that national economies may insulate themselves from the rest of the world. It seems that international cooperation and guidance are needed now more than ever. In hindsight, it seems that “innovation” in the finance industry was simply setting us up for failure. The primary innovation is called “securitization.”

1. A Reliance on Securitization

The goal of securitization is simple: turn a future revenue stream into a present one.\textsuperscript{168} It attempts to take advantage of the benefits of extending credit now instead of waiting until interest accrues and yields profit to the lender. By immediately packaging securities with similar or dissimilar obligations and selling interests in those “pools” to intermediaries, who in turn disperse those new obligations to other buyers, including primarily institutional investors, the originator/lender is able to make a profit on the future revenue stream, assuming full repayment, in the present.\textsuperscript{169} This method is called “originate and distribute,” referring to the treatment of risk associated with default on these obligations. The model was first used regularly in the early 1990s, expanding as these pools were actually used as collateral for other obligations, with the approval of credit rating institutions, creating risk arrangements to complex they effectively became circular.\textsuperscript{170} It seemed many arrangements were effectively self-supported. This pooling,

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Id. at 107.
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selling and re-selling of various invented obligations connected once disparate markets in new ways, and allowed the credit crunch to spread that much more easily once it began to contract.\textsuperscript{171}

These new “invented” obligations, or securitization vehicles, increased over time.\textsuperscript{172} Many of them include the term “collateralized” in their name, referring to the fact that the buyers of these obligations were not so much buying a “piece” of a mortgage, for example, but an obligation backed by a mortgage. That particular obligation is called a CMO, a Collateralized Mortgage Obligation; others include Collateralized Debt Obligations (“CDOs”), Collateralized Loan Obligations (“CLOs”), and Collective Investment Vehicles (“CIVs”).\textsuperscript{173}

Ironically, international collaboration on banking regulations has actually made securitization easier.\textsuperscript{174} By streamlining regulations and standards, transaction costs have decreased, driving down the cost of securitized obligations, and making them more affordable for foreign institutions.\textsuperscript{175} Notably though, reducing transaction and other secondary costs have made non-securitized obligations cheaper as well, and it has not made securitized obligations any more risky. Additionally, securitization allowed risk managers to separate their calculations from those of the credit department—risk managers could work with a pre-set acceptable risk standard and continue to securitize the obligations the credit department issued without increasing risk by supplementing the pools with less risky vehicles including credit derivatives.\textsuperscript{176}

The Gramm-Leach-Bliley Financial Modernization Act of 1998 took down the wall between banks and investment funds and allowed securitization to expand from not only traditional lenders as originators of these new obligations, but to less traditional financial

\begin{flushleft}
\textsuperscript{171} Id. at 92.
\textsuperscript{172} Id. at 93.
\textsuperscript{173} Id.
\textsuperscript{174} Id. at 101.
\textsuperscript{175} Id.
\textsuperscript{176} Id. at 107.
\end{flushleft}
institutions, even further complicating risk structures. But Basel II actually made it worse: “these excesses received regulatory support through the replacement for the 1998 Basel Capital Accord—Basel II.” It allowed risk-mitigation efforts, including supplementing pools with credit derivatives, adding counterparty risk to the already-complicated risk calculation. It also allowed banks to use their internal risk calculations (through the A-IRB Approach) to satisfy requirements through reliance on credit rating agencies who had previously approved of risk mitigation by credit derivatives. These “innovations” not only condoned but also encouraged bad practices adopted by banks.

Aggressive extension of credit would not have set up a problem had the market not financed it. That is the other side of the equation: overinvestment in credit obligations. Low interest rates during the Greenspan era, especially after the “dot com” bubble burst in the early 2000s, as well as in Japan after their banking crisis in the 1990s, allowed the demand for these obligations to skyrocket. As a result, and as it has become clear that as defaults on loans underlying these vehicles dominoed, they were overvalued. Another cause of the financial crisis was the fact that there has been such a stark divide between consuming countries and saving countries—that imbalance arguably has made some of the effects in the global market worse than they had to have been once credit began to contract. At that point, the excessive

177 Id. at 104.
178 Id. at 108.
179 Id. at 109.
180 Id.
181 Id.
182 Id. at 92.
183 Id.
184 Id.
185 Id.
overleveraging only translated unstable risk mitigation through securitization into rampant market default, not only in lending markets, but in all commercial markets.\textsuperscript{186}

2. Precipitating Effects

“As is invariably the case in finance, reasonable ideas were eventually taken to excess and resulted in crisis.”\textsuperscript{187} If securitization, risk mitigation, and investment in credit obligations were reasonable, finance’s reliance on these measures was certainly not reasonable, at least as the credit crisis showed us. If these practices were kept in a box, they might not have had such an effect. But this did not happen, and the ability to originate and distribute, to play with risk calculations, and to invent new obligations out of old ones only confused old practice. Suddenly it seemed banks could offer what two decades ago would have been a bad investment and make it a sure thing, supplementing risk with surety. This practice and the overall competitiveness of the lending industry, particularly in home mortgages, encouraged by an influx of non-traditional lenders and government-backed lenders (Fannie Mae and Freddie Mac), only upped the pressure on traditional lenders. Suddenly things had become so desperate that lenders were offering such things as “NINJA” mortgages, also known as “no income, no job, and no assets” mortgages.\textsuperscript{188} No need for collateral—make them all recourse loans—since the bank could back them up by other similarly risky loans. This rush towards recourse backing has made the effects of credit contraction that much more painful, as home foreclosure volume is just as shocking as the number of failed banks.

\textsuperscript{186} Id. at 106.
\textsuperscript{187} Id.
\textsuperscript{188} Id. at 107.
The crisis began in the subprime mortgage market with more risky mortgages, with Congress having to place its government-backed lenders Fannie Mae and Freddie Mac into conservatorship under the Federal Housing Finance Agency.\textsuperscript{189} With all these mortgages now in trouble, the effects began to ripple through all the obligations used to secure them along with any credit derivatives used to mitigate risk. Particularly, American International Group (“AIG”) was one of the largest counterparties in credit derivatives market.\textsuperscript{190} AIG quickly failed after it was revealed it had taken a loan from the Fed and was subsequently downgraded by credit rating agencies.\textsuperscript{191} Such a downgrade required an uptick in the amount of collateral required to secure its outstanding obligations, an amount that it could not provide.\textsuperscript{192} As a result, the U.S. government took a 79.9\% stake in the company, effectively nationalizing it to resolve its obligations.\textsuperscript{193}

But AIG was not the only monumental failure. Also the week of September 15, 2008, Lehman Brothers failed.\textsuperscript{194} The Bush Administration made the decision not to bail out Lehman, one of the reasons being that it simply could not afford to do so.\textsuperscript{195} As a non-bank financial institution/investment fund, its account holders were not secured, and barring the results of insolvency proceedings and liquidation, all money was lost. Other failures followed, including the closing of Washington Mutual by thrift regulator Office of Thrift Supervision (“OTS”) on September 25, 2008, the largest bank failure in U.S. history.\textsuperscript{196} Failures continue to this day.

\textsuperscript{189} Id. at 113.
\textsuperscript{190} Id. at 114.
\textsuperscript{191} Id.
\textsuperscript{192} Id.
\textsuperscript{193} Id.
\textsuperscript{194} Id.
\textsuperscript{195} Id.
\textsuperscript{196} Id. at 116.
3. Recovery Efforts

Soon after the failure of Lehman, the Securities and Exchange Commission (“SEC”) and the U.K. Financial Services Authority (“FSA”) banned short sales of stock.\textsuperscript{197} The idea was to quickly introduce a stop in the market to reduce its impact on non-lending and non-banking markets. Congress also acted, its main efforts being implemented through TARP, the Troubled Asset Relief Program, in the Emergency Economic Stabilization Act of 2008.\textsuperscript{198} The Act first failed on September 29, finally passing in revised form on October 1.\textsuperscript{199} The main function of TARP was to purchase “troubled” assets, mainly these risky securitized vehicles sitting on the books of struggling institutions, to allow the institutions to get out from under the weight of the now downgraded obligations.\textsuperscript{200} The U.S. Treasury was authorized to buy them, putting them on their books at the Federal Reserve, which has now begun efforts to sell them off in 2010. Other efforts that October included temporary liquidity guarantees, recapitalization programs for struggling institutions, and new insurance for scared depositors.\textsuperscript{201}

Recovery efforts were also evident internationally. The Financial Stability Forum (“FSF”) was established in the wake of the crisis and today competes with Basel in creating a new vision for international financial cooperation.\textsuperscript{202} FSF released a number of suggestions, including establishing better disclosure requirements for banks, reexamining the treatment of certain balance sheet assets and securitization valuation (by the International Accounting

\begin{footnotes}
\footnote{197} Id. at 115-16.
\footnote{199} Arner, \textit{supra} note 168, at 117.
\footnote{200} Id.
\footnote{201} Id.
\footnote{202} Id.
\end{footnotes}
Standards Board), instituting new liquidity standards, regulating credit rating agencies, and forming a credit derivative clearing house.\textsuperscript{203}

The G-20 also released a number of suggestions to reform international cooperation. It suggested the need to mitigate against the pro-cyclicality of the current structure, the need to align global accounting standards, to improve the credit derivatives market, and to redefine the “scope of systemically important institutions.”\textsuperscript{204} A number of the FSF, G-20, and other suggestions will not be discussed in the context of critiques of Basel II.

B. Critiques of Basel II

As mentioned earlier, a number of the innovations of Basel II actually became problems when times got tough in 2008. Particularly, the reliance on internal measurements (the A-IRB Approach) and the allowance of risk mitigation by credit derivatives allowed securitization to spread beyond what would have been reasonable. Although such innovations did not trigger the credit crunch, instituting such changes did not stand in the way of such natural contraction from becoming a full-fledged crisis.

In considering the weaknesses of Basel II, most of my critiques and suggestions arise from a legal, not economic, analysis. Where reforms are purely economic in nature and do not relate to the overall structure of implementation of the system, I have assumed the underlying economic theory is sound and do not affirm any such conclusions. The following criticisms and related suggestions are therefore just the beginning—they are evident to me even without reexamining our macroeconomic assumptions. If regulators agree to to common definitions,

\textsuperscript{203} \textit{Id.} at 119.
\textsuperscript{204} \textit{Id.} at 120.
categories, and supporting practices, then we can examine whether our economic theory is sound.

1. Advanced IRB Approach

One or the more pointed criticisms of Basel II is its use of the A-IRB approach for valuing item risk. As a result of Basel II allowing banks to internally calculate some of its own risk, there has been an increase in the time, effort, and money dedicated to such risk calculations.\(^{205}\) It is not clear, however, that such efforts have actually made banks sounder. The crisis speaks to the hypothesis that this attention simply allowed banks to take advantage of the flexibility and skirt the spirit of the capital requirements rather than making their own internal policies more attune to them. The approach was the gateway for a number of other problems.

2. Pro-cyclicality

One of the consequences of Basel II, which actually a carryover of Basel I, is that the pro-cyclical effects of regulation are encouraged, not discouraged.\(^{206}\) This phenomenon is explained in the context of the natural expansion and contraction of the economy. While regulation’s goal may be to mitigate the troughs during contraction, it often also reduces the peaks during times of expansion. This would be considered countercyclical—the goal of mitigating the effects during times of recessions. What Basel has arguably done is the opposite: pro-cyclicality. It has tended to lengthen or deepen the recessionary periods, because while

\(^{205}\) TARULLO, supra note 59, at 177.

\(^{206}\) Id. at 178.
capital requirements prevent institutions from extending so much credit that the economy “overheats,” such restrictions prevent recovery when natural times of contracting credit come in.\textsuperscript{207} Some fear the A-IRB approach has made this pro-cyclical tendency more pronounced because reliance on internal formulas may mix up the calculations of actual versus projected risk.\textsuperscript{208} If Basel were to relax capital requirements, calculations would be less useful in determining actual risk, though they might relieve pro-cyclical pressure.\textsuperscript{209}

3. Regulatory Arbitrage and Competitive Equality

Another concern, which rings sound to the domestic regulator as well as to the international one, is that of regulatory arbitrage, or competitive equality. Basel treats all banks similarly, and many small institutions that are given more latitude under national regulations might, as a result, be put at a competitive disadvantage since they might be less able to take full advantage of the A-IRB approach compared to a large institution.\textsuperscript{210} For example, certain types of loans require less collateral, including those for established commercial firms more likely to bank with larger institutions.\textsuperscript{211} This competitive disadvantage might, and arguably has, resulted in bigger banks getting bigger and has pushed struggling community banks into insolvency.\textsuperscript{212} To survive, such struggling institutions might be pushed to take on more risk, further

\begin{footnotesize}
\begin{enumerate}
\item Id. at 78.
\item Id. at 178.
\item Id. at 180.
\item Id. at 182-83.
\item Id. at 183.
\item Id.
\end{enumerate}
\end{footnotesize}
destabilizing the market.\textsuperscript{213} Finally, such a migration might not end with smaller community banks but with non-banking institutions at the edge of, or outside, current regulation.\textsuperscript{214}

4. Inconsistent Implementation and Enforcement

Another problem with the Framework is its inconsistent implementation and enforcement. This problem is obviously an international one, but is also a national one, further incentivizing regulatory arbitrage in the U.S. Because the Framework standards are the product of cooperative efforts, it is up to national regulators to implement them. They have to do this within their own statutory and administrative limitations, so the effect of such efforts differs across nations. Particularly, the implementation of standards in developing countries is wanting.\textsuperscript{215}

In addition to actual implementation, there has been no consistent external enforcement of these standards until recently. The IMF and the World Bank have begun to monitor enforcement of the standards, but the organizations have little power to do anything about problems they find.\textsuperscript{216}

5. Separation of Risk and Credit Extension

\begin{footnotesize}
\textsuperscript{213} \textit{Id.}.
\textsuperscript{214} \textit{Id.} at 184.
\textsuperscript{216} \textit{Id.} at 296.
\end{footnotesize}
As previously mentioned, the separation of risk and credit extension calculations prevented the right hand from knowing what the left was doing. The ability to mitigate risk by inserting credit derivatives in pools allowed credit to continue to flow unabated without risk managers having to retool.\(^{217}\) Just as the securitized obligations are largely unregulated (at least by something such as a common clearinghouse), credit derivatives are also unregulated. In the end, it seems that even institutional investors did not actually know what they were buying when they bought CMOs, CDOs, and CIVs, and therefore, they could not build their own risk formulas to properly account for their new acquisitions.

C. Basel III and the Future

1. Potential for a New Agreement

In his interview with the *Wall Street Journal*, Lord Turner indicated that a new Framework is in the works.\(^{218}\) Perhaps it is needed, not only to improve upon shortcomings of Basel II, but also to allow implementation that is not as flawed as Basel II. Tarullo concludes that “the Basel II process was launched without an adequately develop set of goals.”\(^{219}\) What resulted appears to be overstretched, over-compromised, and inadequately implemented by national regulators. A potential Basel III should focus on fewer things than Basel II and do them well. Primarily, Lord Turner indicates that the Committee is considering how a new arrangement might fight the pro-cyclicality of banking regulation, enough so as to become countercyclical.\(^{220}\) In that way, limitations on capital and credit extension might be in place during boom times in

\(^{218}\) FSA, *supra* note 6.
\(^{219}\) TARULLO, *supra* note 59, at 135.
\(^{220}\) FSA, *supra* note 6.
order to prevent the too-quick expansion of credit, without being a drag on recovery after a recession when riskier arrangements might be warranted. Such a flexible Framework would be welcome in the shadow of a big bear market, because the goals of the BIS and of Basel should not just be to fight the inequality that exists when financial institutions are not regulated internationally. Basel II indicated that it was intended to “further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally banks.”

Inequality is no threat in the absence of a robust global economy; Basel III should not stifle economic growth.

2. Possible Reforms

The following reforms are a sampling of the more prevalent specific suggestions made by regulators and commentators. Naturally, issues underlying each of these changes overlap, and there are innumerable variations that policymakers could prefer related to each possible reform.

a. Redefine Capital

Although Basel II’s negotiations included proposals for redefining capital, it did not ultimately follow through on any changes. Particularly, core, or Tier 1, capital must be stable, or else comparing it against other items on balance books does not do any good for ensuring safety and soundness. It should not contain items that are only partially true capital (hybrid

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221 Basel II, supra note 176, ¶ 4.
222 TARULLO, supra note 59, at 264-65.
capital), and such items need to be transparent to all parties doing business with the financial institution.\textsuperscript{223} 

b. Raise Capital Requirements

Gregory Mankiw, a Harvard economist and former Chairman of the Council of Economic Advisers for George W. Bush, suggests that the costs of raising capital requirements higher than a theoretical equilibrium are outweighed by the costs of setting them too low.\textsuperscript{224} In other words, we should err on the side of higher than lower capital requirements.\textsuperscript{225} A banking system (and market) can continue to effectively function with more capital than necessary being set aside, but the system can fall apart if it is set too low.\textsuperscript{226}

c. Institute an International Leverage Rule

Capital requirements could be supplemented with a leverage rule. With the A-IRB Approach allowing banks to depend on their own internal calculations for many balance sheet items, a firm leverage rule would require such internal calculations to, at minimum, disallow

\textsuperscript{223} Id. at 265.
\textsuperscript{225} Id.
\textsuperscript{226} Id.
excessive overleveraging. Additionally, a capital-to-revenue ratio could also supplement the A-IRB Approach and set more boundaries for banks to internally value their assets.

d. Institute a Subordinated Debt Rule

Daniel Tarullo also suggests instituting a subordinated debt requirement to strengthen Pillar Three, Market Discipline, for systemically important institutions. By instituting a threshold for subordinated debt, large banks would be prevented from internally collateralizing risky obligations. The proposal would also give investors more confidence in valuing the assets originating with these institutions.

e. Institute a GDP Rule

Simon Johnson, a Professor at the Massachusetts Institute of Technology Sloan School of Management, proposes that U.S. implement a rule limiting the size of banks. Though he suggests this reform in the U.S. context, it could also be applied internationally, requiring any bank operating outside their charter country to follow the rule, either by being unable to operate in smaller nations or by forming subsidiaries with separate books independently satisfying capital requirements. Johnson’s concerns echo back to the foundations of the now-repealed

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227 TARULLO, supra note 59, at 266.
228 Id. at 267.
229 Id. at 270.
230 Id. at 272.
Glass-Steagall Act, which set up a separation between banks and investment firms. Glass-Steagall was repealed with the passage of the Gramm-Leach-Bliley Act of 1998, allowing for a more European-style approach to regulation, treating all financial institutions similarly rather than drawing insurmountable lines. This is the essence of the proposed Volcker Rule, which would prevent consumer banks from extending deposits through proprietary trading on behalf of the firm and not the depositor.

How could Congress construct a rule? Johnson actually proposes expanding the Riegle-Neal (Interstate Banking) Act, which limits the percentage of retail deposits on bank may accept, and expanding it to apply to overall assets and liabilities, since commercial banking is now such a small percentage of what the largest banks do. Specifically he recommends a limit set at four percent of current U.S. GDP, which would restrict the activities, or force reorganization, of the six largest U.S. financial institutions. Could raising capital requirements do the same thing? Johnson argues it would not, since even if capital were set at 100%, the sheer size of banks would pose a risk to the economy. The GDP Rule then might even be constructed to give banks an option, either as “banks” or “investment firms,” or as “safe banks” or “risky banks,” making it obvious to consumers what sort of risk they take when depositing with a particular institution.

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232 Id.
233 Arner, supra note 168, at 104.
236 Id.
237 Id.
238 Diane Rehm Show, supra note 231.
Gregory Mankiw would likely agree. He states that the idea of “safe banking,” a term also used by Johnson, is still viable. Safe banking would follow what Johnson calls “3-6-3” banking, accepting deposits at a three percent rate of return, lending the money back out at six percent, then going golfing at 3:00 P.M. Banking under this model might also be limited to something nearing a 100% leverage rule, as discussed above, and might fall under the first of Johnson’s two options. Mankiw dismisses concerns that such requirements would limit the profitability and, therefore, the viability of financial institutions. If the services offered by such banks were limited, they could still compete and fight for profits by more efficiently delivering those services.

f. Simplify the A-IRB Approach

Tarullo also suggests reforms for the A-IRB Approach. To review, the approach allows banks to use certain internal measurements in determining risk for items on their balance sheets. The credit crisis would seem to suggest that banks have been given too much latitude in this realm, so supplementing this latitude with other minimums, including leverage or subordinated debt rules, would surely help to standardize best practices. On the other hand, maybe it is the A-IRB Approach that should change. While eliminating the option is not likely, says Tarullo, some simplification would help. For example, the ability to restrict use of the A-IRB Approach might be passed along to national regulators, requiring a modified approach or even disallowing

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239 Wessel, supra note 224.
240 Diane Rehm Show, supra note 231.
241 Wessel, supra note 224.
242 TARULLO, supra note 59, at 273.
243 Id.
the approach entirely for systemically important institutions.\textsuperscript{244} The goal would be to make capital levels more readable by regulators closest to the ground.\textsuperscript{245}

g. Disclose Risk Estimates

Basel II reformed capital requirements primarily to make the Framework more accurately account for risk.\textsuperscript{246} Concerns remain about the introduction of the A-IRB Approach, so it is an open question whether Basel II is actually any more “risk-sensitive” than its predecessor. Nevertheless, if the Framework cannot be both flexible enough and strict enough to actually contain bank risk, it can at least work to improve risk disclosures. In the absence of a clearinghouse that would control the dissemination of all investment vehicles, standard disclosures would better inform the investor, individual and institution, about what they are buying. The more information that is available about individual obligations, the better equipped investors will be in calculating their own risk formulas.

h. Strengthen Committee Monitoring Functions

With national regulators having discretion over the definition of capital, for example, the effectiveness of capital minimums differs across borders.\textsuperscript{247} This reduces the effectiveness of the Framework in general if there is no guarantee that the Framework will be interpreted in the same

\begin{flushleft}
\textsuperscript{244} Id. \\
\textsuperscript{245} Id. at 274. \\
\textsuperscript{247} TARULLO, supra note 59, at 265.
\end{flushleft}
way by implementing nations. Basel might do well to, at a minimum, monitor these interpretations so that it can, through amendments to the Framework, best respond to problems of ambiguity. This monitoring could be in the form of a periodic review of certain institutions as a sampling of implementation and respective compliance.248

i. Coordinate Maturities

Mankiw wonders whether the ability to mismatch (or “transform”) maturities, whereby a bank can borrow short and lend long, is actually critical to the success (and profits) of our banking system.249 Such transformation ability only complicates the risk calculation banks have to perform internally, and it raises doubts as to the usefulness of black and white requirements in the Framework. If maturity transformation is not necessary to be able to translate credit extension into a profitable business, then it might not be worth the risk.250 Perhaps Basel should require assets having a particular maturity to be matched up with an equivalent debt asset.

j. Institute Accounting Standards

The FMF’s focus on the International Accounting Standards Board (“IASB”) coordination efforts deserves attention. By coordinating accounting standards internationally, large systemically important institutions (for the global perspective) are not allowed to take advantage of holes created by disparate accounting practices. If Basel, the IMF, and the World

248 Id. at 276.
249 Wessel, supra note 224.
250 Id.
Bank were to enforce compliance with the IASB’s standards, Basel would have a common accounting language on which to build its revised Framework.

3. Three Suggestions

So what reform is actually good? Considering Basel through a federalist perspective, it should have a superior, but separate and distinct role from national regulators. It should not do what national regulators do better, but do something different, especially what national regulators cannot do. Three general suggestions are below, gleaned from more specific suggestions in the previous section. These suggestions would not prevent another crisis, but they give national regulators the tools to do just that.

First, item language. Nations need a common set of definitions to work with. Specifically, the definition of capital needs to be improved, as is discussed above. But definitions need to be set out in other ways. Basel should establish definitions for types of financial instruments, with strict requirements and publicity of groups. If a financial institution wants to invent a new instrument, it would need to fit it under one of Basel’s allowed instrument types, not require Basel to respond and judge its risk. If it does not fit, it should be given the highest risk rating possible under the requirements. Such predefined items would allow aggregate risk to be more easily determined. The burden for proving mitigated risk is then on the institution.

Second, institution categorization. If Basel wants to raise capital or other requirements, it needs to draw some clear lines between those institutions allowed to take on risk and those not allowed to take risk. If it wants to categorize safe banks, it needs to support that categorization with educational efforts and public relations so that depositors understand the sort of institution
in which they are depositing. This would do away with the need to create so much flexibility in
the rules in order to accommodate different sorts of institutions that the rules are easily evaded.
This sort of reform might be useful in the national context, but it is more useful in the
international one, so that an institution could not mold itself to fit between categories due to
differences in national standards. Such a move would be toward the American standard in
regulation, Glass-Steagall, which separated banks from investment firms, rather than following a
more European common approach. This change would also alleviate competitive equality
concerns that a unified approach is disadvantaging smaller banks.

Finally: supporting standards. Basel needs to focus particularly on accounting standards.
This effort should begin with definitions of capital and instruments, but it should go further,
setting binding international accounting standards so that institutions could circumvent capital
and other risk requirements set out by a new Framework.

V. Conclusion

As this final draft has been being prepared, Basel has already been acting. It seems a new
Framework is in the works—the Basel Committee on Banking Supervision released a
changes to the Framework, presumably in preparation for a new Framework, referred to by the
Committee as a “comprehensive Reform package.”\footnote{Strengthening the resilience of the banking sector – consultative document, Dec. 2009, http://www.bis.org/publ/bcbs164.htm.} The proposals are in response to fallout
from the financial crisis and move to implement a number of changes suggested to prevent a similar crisis and are in coordination with the Financial Stability Board and the G-20 who are also conferring on possible post-crisis reforms.\textsuperscript{253} Much of the blame for the crisis lies in the regulation (or lack thereof) of financial innovations, including securitized obligations and credit derivatives. While such innovations allowed for unprecedented growth in the early 2000s, they also left in their shadows incalculable risk should the system begin to crumble. The proposals seek to “promote a better balance between financial innovation and sustainable growth” rather than removing such innovations from the game of play.\textsuperscript{254}

The package is summarized by its focus on five key changes. First, it moves to strengthen the capital base, particularly Tier 1.\textsuperscript{255} This would be in terms of “quality, consistency and transparency.”\textsuperscript{256} The definition of Tier 1 capital would be tightened, and more capital would be required relative to Tier 2. There has been much talk about raising capital levels, the conclusion a simple one: banks were not adequately protected when credit contracted, so capital levels need to be raised. It’s the simplest conclusion one can draw when evaluating the adequacy of the Framework requirements in light of the Great Recession, but it’s just that—simple. Either national regulators or Basel should require more than simple capital reforms, though raising capital is a good start.

Second, the package proposes to “strengthen[] the risk coverage of the capital framework.”\textsuperscript{257} More specifically, the changes would strengthen the capital requirements for

\begin{footnotesize}
\textsuperscript{253} \textit{Id.}
\textsuperscript{254} Consultative proposals, \textit{supra} note 251.
\textsuperscript{255} \textit{Id.}
\textsuperscript{256} \textit{Id.}
\textsuperscript{257} \textit{Id.}
\end{footnotesize}
counterparty credit risk exposures.\textsuperscript{258} This would include increasing the capital requirements to offset credit derivatives, repossession agreements, and securities financing activities.\textsuperscript{259} The Committee suggests these changes to maintain the ability of banks to use financial innovations, but requiring them to properly account for them on their balance sheets, in disclosing them to the public, and in accounting for reasonable counterparty risk.

Third, the package proposes to introduce an overall leverage ratio.\textsuperscript{260} This is the third leg in the effort to better regulate financial innovations. While capital improvements strengthen one side of the risk equation and better regulation of counterparty exposures focus on the other, the leverage rule would bring the two together. The rule would target the build-up of risk arising from items not categorized on the balance sheet so that financial innovations Basel has not had a chance to contain will be factored into the greater requirements.\textsuperscript{261} The leverage ratio would compare capital base items against certain credit risk items.

Fourth, the Committee seems set to quell one of the concerns about Basel I and II (and most financial regulations)—pro-cyclicality.\textsuperscript{262} To review, regulations are pro-cyclical because although they reign in out-of-control growth (through excessive risk-taking) with an eye on avoiding steep falls, they also restrict the ability to recover from crises since banks have less flexibility to extend credit. More simply, pro-cyclical regulations prevent banks from extending too more credit, but prevent banks from extending enough credit to recover. If these regulations attempt to make the troughs of financial cycles less deep by correspondingly shortening peaks, they extend the periods—and that goes for the bearish times as well as the bullish ones.

\textsuperscript{258} Id.
\textsuperscript{259} Id.
\textsuperscript{260} Id.
\textsuperscript{261} Id.
\textsuperscript{262} Id.
Countercyclical regulations would theoretically prevent the hard falls without limiting the ability to recover from a crisis. To do this, regulations have to be flexible—rules would be in place during times of expansion, but would be eliminated or limited during times of contraction. The package proposes to make some of the capital requirements countercyclical in this way.\textsuperscript{263} With this as a goal, the Committee proposes to revise the categorizing of expected losses in a way that gives more flexibility to institutions perceiving changes in the market, rather than requiring a certain level of reliance on past losses as a benchmark for future ones.\textsuperscript{264}

Similar to a leverage ratio, finally, the Committee proposes to introduce a liquidity rule. Liquidity is often viewed in the very short term, considering only preventing runs on banks like the Great Run of 1929. But Basel’s proposal is a 30-day liquidity standard, requiring banks to be able to able to float for weeks in times of dire crisis, not just overnight. The rule would be “underpinned by a longer-term structural liquidity ratio” that would take into account unique elements of each institution.\textsuperscript{265}

The Committee asked for comments on the consultative package by April 16, 2010.\textsuperscript{266} To be kind, banks have not been supportive of the proposed changes, which should not be particularly surprising.\textsuperscript{267} While some of the changes are more adjustments by degree, including the higher capital requirements and even the overall leverage rule, banks have reserved the most ire for the liquidity rule. The rule is based on a ratio projecting 12 months of capital flow, a requirement banks say would require them to drop large amounts of short-term debt and replace

\textsuperscript{263} Id.
\textsuperscript{264} Id.
\textsuperscript{265} Id.
\textsuperscript{266} Id.
it with longer-term obligations. U.S. Banks also oppose the inclusion of credit derivatives in capital calculations—while this has long been the practice of European banks, U.S. regulators have allowed banks to net these items when adding up risk items. Another universal concern is the speed of implementation of such rules if Basel adopts them—if implemented too quickly, they could stifle whatever recovery momentum the industry has recovered, though Basel is unlikely to adopt any of the proposals until 2012.

The U.S. will likely pass reform before 2012. In fact, it appears that the Senate will pass reform package for domestic regulations during the late spring or summer of 2010, with a compromise House/Senate package on President Obama’s desk sometime in the fall. Reform arises in a few areas: rearranging the national regulators, institutionalizing the focus on systemic risk, increasing the focus on consumer protection, regulate derivatives, and limiting the proprietary activity of depository institutions. The House bill, which passed on Dec. 11, 2009, gives the Federal Reserve the authority to regulate the nation’s largest financial firms, even if they aren’t banks. The Senate bill, currently being debated on the floor, does the same thing, but it also removes state-chartered Fed-member banks, which the Fed currently regulates, and placed them under the FDIC. The FDIC currently regulates state-chartered non-Fed-member banks. Similarly, both bills eliminate the savings and loan regulator the Office of Thrift

268 Id.
269 Id.
270 Id.
272 Id.
273 Id.
Supervision, merging it into the Office of the Comptroller of the Currency, a part of the Treasury Department.\textsuperscript{274}

That focus on “systemic risk” goes further—both bills create a Financial Services of Financial Stability Oversight Council (“FSOC”) to monitor institutions that are systemically important, or “too big to fail” where there may be an implicit guarantee by the federal government to protect those firms should they encounter trouble.\textsuperscript{275} The FSOC in both bills is charged with the management of a fund financed by fees on these firms that can pay for the dismantling by new special liquidation procedures should a systemically important firm fail.\textsuperscript{276}

The House bill creates an independent Consumer Financial Protection Agency, given the authority to write broad rules regulating mortgages, credit cards, and other consumer-focused products, whether issued by banks, credit unions (who are primarily regulated by states), or other financial institutions.\textsuperscript{277} The Senate bill, on the other hand, has been the subject of compromise and controversy, the current form placing the agency within the Federal Reserve, but with an independent director and separate budget.\textsuperscript{278} Also different, the Senate bill limits the ability to enforce its rules to institutions over $10 billion.\textsuperscript{279}

Both the House and Senate bills attempt to regulate credit derivatives, giving new authorities to see the issuance of such items and their trading to the SEC and the Commodity Futures Trading Commission.\textsuperscript{280} The Senate bill also acts on a proposal suggested by the White House and named after former Federal Reserve Chairman Paul Volcker that limits the ability of

\textsuperscript{274} Id.
\textsuperscript{275} Id.
\textsuperscript{276} Id.
\textsuperscript{277} Id.
\textsuperscript{278} Id.
\textsuperscript{279} Id.
\textsuperscript{280} Id.
banks to own or invest in hedge funds or engage in other proprietary trading activities. The idea is to create some separation between banks, which since Gramm-Leach-Bliley have been able to merge with and acquire other financial institutions, by forcing their activities to be on behalf of depositors, not shareholders or management. The House bill does not impose such requirements, but it does give the SEC the power to regulate hedge funds and private equity funds.

Assuming the Senate passes a bill, the House and Senate will have to combine the two bills in a conference committee. If those bills are as different as they are now in committee, it will not be an easy process, because each is based on a different philosophy and understanding of the underlying problems. The conference needs to produce a philosophically coherent law; otherwise what results will not only fail to remedy any underlying problems, but might complicate some of the symptoms of any future credit or liquidity crisis. The same thing might happen if the recovery in the U.S. differs from that in other nations, particularly in the developed world, creating imbalances that could lead to instability that could limit recovery, a result that Basel II might never have been able to prevent. Tarullo notes that the “Basel Committee itself had implicitly acknowledged that the revised framework would not have been adequate to contain the risks revealed by the sub-prime crisis and needed strengthening.” So if Basel II, even fully implemented, does not coordinate efforts enough to both allow optimal recovery and further prevent crises in the credit markets, then perhaps a new Framework is needed. Hopefully the Committee is well on their way to producing a reasonably, philosophically coherent, and effective alternative to Basel II.

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281 Id.
282 Id.
283 TARULLO, supra note 59, at 4.
Treasury Secretary Timothy Geithner has emphasized the need for a global response to the crisis encompassing controls within the Basel purview as well as regulatory oversight handled by national regulators. With both the G-20 and Basel moving towards major changes, formal coordination in other areas is doubtful. National representatives fear that failing to expand coordination will leave companies rushing to the bottom, taking advantage of the fewest restrictions. These efforts are particularly important for the U.S. and Europe, including the vast majority of the world’s capital markets. Although the European Central Bank implements monetary policy through the euro, there is no European-wide financial institution regulator and no common reserve requirement to raise capital levels in the way the Fed does in the U.S. Despite this additional hurdle, most European countries have taken different approaches than the U.S. in regulating the financial industry. Geithner has opposed Europe’s strengthened regulation of large investment funds, along with prohibiting certain derivatives in light of the Greek debt crisis, while the U.S. has gone further in requiring transparency and reigning in executive compensation.

There is no need for Basel to replace all national regulation of financial institutions, or even replace the discretion national regulators have. Saving the world’s economy from another collapse is too big a job for one entity. In fact, certain rules need to be local—for example, the Committee is not in a position to determine what size and sort of interconnected institutions are systemically dangerous, or “too big to fail,” for a particular country. In the international perspective, a financial institution may not be systemically risky, but it might within a national

285 Id.
286 Id.
context. What Basel and its Framework should do instead is establish a structure and a language upon which national regulators can decide the sort of risk allowed to be able to participate in the local economy. Coordination does not require raising capital levels to effectively eliminate all risk, but it should better categorize risk, define capital, and set boundaries between banks and investment or other financial firms. And it should also set out accounting standards so that these lines are not blurred by local accounting practices. The Basel Committee does not need to save the global economy, but it can help national regulators do just that.