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Abhandlungen

The Political Economy of Banking Regulation – Does the Basel 3 Accord Imply a Change?

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Abstract

Literature on the international financial architecture suggests that financial crises have had profound effects on both the balance of power in the establishment of financial regulation, and the economic impact of regulation on countries and regulated entities. In this article, we seek to add to this knowledge by studying the process by which the Basel Committee on Banking Supervision (BCBS) developed its third capital accord, the so-called Basel 3 accord. We also describe changes in BCBS's governance and standard setting process, and ask whether these may have caused the economic impact of Basel 3 to differ from the Committee's preceding capital accords (Basel 1 and 2). Our findings indicate that while BCBS still seem to develop standards that favor their traditional member countries, large international banks no longer seem as clearly favored by its latest capital accord. And while private actors still seem to dominate the exertion of influence over the committee, the governance structure of BCBS has changed towards a more transparent and politically accountable set-up. (F53, F59, P11, P16, G28)

Zusammenfassung

Die politische Ökonomie der Bankenregulierung – Führen die Regulierungsvorschriften Basel-III zu Veränderungen?

Die Literatur über die internationale Finanzarchitektur beinhaltet, dass Finanzkrisen einen tiefgreifenden Einfluss auf das Gleichgewicht der Kräfte bei der Einführung von Finanzregulierungen sowie wirtschaftliche Auswirkungen auf Staaten und auf staatlicher Regulierung unterliegender Instanzen ausüben. Mit

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diesem Artikel wollen wir diese Kenntnisse erweitern, indem wir uns mit dem Prozess befassen, in dessen Verlauf der Baseler Ausschuss für Bankenaufsicht (Basel Committee on Banking Supervision (BCBS)) seine Reformen – die sogenannten Basel-III-Regulierungsvorschriften – entwickelt hat. Wir beschreiben auch Veränderungen in der Regierungsführung sowie der Regulierungstätigkeiten des BCBS, und wir stellen uns die Frage, ob diese für die wirtschaftlichen Auswirkungen der Basel-III-Regulierungsvorschriften deshalb verantwortlich gewesen sein können, weil sie sich von den zuvor geltenden Kapitalvorschriften (Basel I und II) unterscheiden. Die Ergebnisse unserer Nachforschungen deuten darauf hin, dass, während der BCBS immer noch Vorschriften zu entwickeln scheint, die eher seinen traditionellen Mitgliedsländern zugutekommen, international operierende Großbanken von den zuletzt entwickelten Kapitalvorschriften nicht mehr so klar favorisiert zu werden scheinen. Und während nichtstaatliche handelnde Personen bei der Ausübung von Einfluss auf den Ausschuss immer noch dominant zu sein scheinen, hat sich die Steuerung durch das BCBS in Richtung auf eine transparentere und politisch verantwortungsvollere Struktur gewandelt. (F53, F59, P11, P16, G28)

I. Introduction

Significant theoretical advancements have been made since the time when international organization were seen as mere efficiency enhancing solutions to coordination problems and information asymmetries (for a discussion, see *Singer* (2004); *Snidal* (1996)). In the last decades, theoretical perspectives have stressed three circumstances that imply that international organizations not only behave in ways that simply reflect the preferences of rationalist states (cf. *Finnemore* (1993); (1996); *McNeely* (1995)). Firstly, it has been demonstrated that private actors has been able to acquire a rule-setting role in their influence over international organizations constituted by state representatives – often as a consequence of the detailed technical knowledge needed to argue for one rule or another (*Mattli/Büthe* (2005); *Porter* (2005); *Sinclair* (2002); *Tsingou* (2003); *Cohen* (2008)). Secondly, it has been recognized that international organizations not only reflect the preferences of their members or influential outsiders. They can also acquire a life of their own, with large degrees of independence and powers to pursue their own agendas (*Barnett/Finnemore* (1999)). Finally, it has become apparent that the agendas and powers of rule-setting international organizations have wide implications beyond their constituencies or the immediate area of their regulatory scope (*Bailey* (2005); *Claessens* et al (2009); *Blom* (2009)). Taken together, these three circumstances raise justifiable questions on the accountability and legitimacy of international organizations.

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The widely-debated internationalization of the policy-making process in monetary and financial affairs (or so-called international financial architecture (*Eichengreen* (1999); *Fisher* (2004); *Fisher/Truman* (2004)), is a telling example of how the legitimacy and accountability of rule-setting international organizations may be questioned. The Basel Committee of Banking Supervision (BCBS), an international standard setting body constituted by national supervisory authorities and central banks of 24 member countries, and itself part of the international financial architecture, is in many ways a textbook example of the above.[2] Research has shown that BCBS allows private interest a large say in its standard setting process. This is nothing new in the area of banking regulation (*Coleman* (1996); *Moran* (1986)), but in recent years private involvement has increased (*Cohen* (2008); *Underhill/Zhang* (2008); *Claessens* et al. (2009); *Blom* (2009)). BCBS's decisions are consensus based, and are formulated with very limited influence from non members countries and other interests than those of the financial industry in advanced countries. Also, by pursuing consensus based decisions, BCBS has tended to opt for secrecy rather than transparency (*Alexander* (2005)). Even though the transparency and extent of interaction with (typically developing country) nonmembers increased, when BCBS conducted the consultative rounds when it developed its influential second capital accord (the so-called Basel 2) (*Blom* (2009)), many still consider the BCBS to represent a concentration of power with a flawed governance structure and insufficient accountability (*Underhill/Zhang* (2008)).

Some researchers attribute the outcomes of BCBS's standard setting to its opaque governance structure, exclusionary nature and secretive mode of interacting with few outsiders other than representatives of large financial institutions (*Bailey* (2005); *Claessens* et al. (2009)). It has indeed been shown that BCBS's standards tend to favor large financial firms; Basel 2 allows banks to develop their own risk management approaches and models of calculating risk weights (that in turn impact on capital ratios) under the approval of supervisory agencies. This typically benefits large banks that have sufficient resources (*Blom* (2009)) and creates a competitive disadvantage for smaller banks (*Alexander* (2005)). In turn, this also implies a negative impact on developing countries, since their banking industries typically have been less developed and with fewer large international firms (*Bailey* (2005)).

[2] For more details on BCBS, see Section 2 or www.bis.org/.

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In this article, we seek to reassess the above notions of BCBS by studying its third capital accord (the so-called Basel 3). Previous crises have had profound effects on the international financial architecture in terms of balance of power, governance and economic impact (*Eichengreen* (1999); *Fisher* (2004); *Fisher/Truman* (2004), *Bengtsson* (2011)), so it has been anticipated that the global financial crisis of 2007–2009 will change the nature of global standards of banking regulation (*Underhill/Zhang* (2008)).

More specifically, we analyze a) the recent changes in the governance structure of BCBS; b) the process in which Basel 3 was developed; and c) the anticipated effects of Basel 3 on different types of banks and categories of countries. We also look for patterns in a) to c) to assess whether changes in BCBS's governance and standard setting process may mean that the economic impact of Basel 3 differs from the BCBS's preceding capital accords (Basel 1 and 2). Our findings indicate that while BCBS still seem to develop standards that favor their traditional member countries, large international banks no longer seem as clearly favored by its latest capital accord. And while private actors still seem to dominate the exertion of influence over the committee, the governance structure of BCBS has changed towards a more transparent and politically accountable set-up.

In the following section, we describe changes in the governance structure of BCBS that has occurred since the establishment of the committee's previous accord (Basel 2). In section III., a brief account of the process of establishing the Basel 3 framework is provided, and Section IV. describes the consultative round. Section V. focuses on the expected impact of Basel 3 on types of banks and categories of countries. In section VI., we reflect on the findings of the previous sections and conclude.

II. Structural Changes in Banking Regulation Standard Setting

BCBS is a standard setting body created by G10 central banks in 1974. Comprising central banks and supervisory authorities, it sets voluntary standards on banking supervision and regulation. It is most well-known for its international standards on capital adequacy, the so-called Basel accords, named after the Swiss town in which the Bank for International Settlement (which hosts the secretariat of BCBS), is situated. Basel 1 was released in 1988 and Basel 2 in 2004 (*BCBS* (1988); (2004)). BCBS's standard setting decisions are reached by consensus and subject

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to endorsement by the member states' central bank governors and heads of supervision (GHoS). Although BCBS does not have any supranational powers, its standards are widely followed across both developed and developing countries around the world.

But despite the extensive global adherence to BCBS's standards, membership in the committee has since its founding been restricted to central banks and supervisory authorities of advanced economies. This changed somewhat after the global financial crisis, as BCBS membership was extended to G20 in 2009. In March Australia, Brazil, China, India, Korea, Mexico and Russia were included, followed by Argentina, Indonesia, Saudi Arabia, South Africa and Turkey in June. The expanded membership was meant to create more globally relevant standards of banking supervision: "The newly expanded membership will enhance the Committee's ability to carry out its core mission to strengthen global supervisory practices and standards. It will also help to more effectively implement the necessary reforms of the international financial system. Basel Committee broadens its membership" (*BCBS* (2009)).[3] It is striking that eleven of the twelve new members are emerging market economies (all but Australia).[4]

But the crisis did not just alter BCBS' membership. As the Financial Stability Board (FSB) was established, BCBS and GHoS also became subject to its approval and directional guidance. FSB reports to G20, and is mandated to undertake strategic review of the work by standard setting bodies: "to assess vulnerabilities affecting the global financial system and identify and review on a timely and ongoing basis the regulatory, supervisory and related actions needed to address them, and their outcomes", as well as to "undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities and addressing gaps" (*FSB* (2009)). Subsequently, at the Los Cabos meeting of the G20

[3] Also, in recent years, BCBS has also embarked on an outreach program, to cooperate with and assist a number of supervisory groupings from emerging and developing countries (*BCBS* (2009b)).

[4] The concept of what constitutes an emerging market is debated. In this article, we categorize countries as emerging markets when they are classified as such on any of the major index providers, credit rating agencies, investment banks and other organizations that regulatory provide lists of emerging markets (IMF, Next-11/BRIC, CIVETS, FTSE, MSCI, The Economist, S&P, Dow Jones, BBVA, Columbia University and EMGP). According to such a categorization, Brazil, China, India, Korea, Mexico and Russia, Argentina, Indonesia, Saudi Arabia, South Africa and Turkey are emerging markets.

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in 2012, FSB was given a wider remit over global standard setters, and plans to strengthen its independence and resources were approved (*Jones* (2012)).[5]

FSB's decisions are reached by consensus of its plenary. Plenary members consist of 64 bodies from 24 countries. The number of seats assigned to each country depends on the size of the economy, its financial market activity and financial stability arrangements (*FSB* (2012a)). Eleven countries have three representatives, typically one each from the central bank, supervisory authority and treasury (UK, US, Brazil, China, France, Germany, India, Italy, Japan, Russia and Canada). Spain, Switzerland, the Netherlands, Mexico, Korea and Australia all have two representatives, where one is from the treasury and the other from either the central bank or supervisory authority. The remaining FSB member countries (Argentina, Hong Kong, Indonesia, Turkey, South Africa, Saudi Arabia and Singapore) merely have one representative each. Central bank represents all of these, apart from South Africa, where the treasury is the plenary member.

A steering committee that sits between the FSB chairman and the members is largely responsible for setting the agenda for the BCBS. According to FSB's charter (*FSB* (2012a)), the steering committee provides operational guidance to enable plenary fulfill its mandate, including inter alia preparing "options for decisions of the plenary" (p. 6). Not all member countries are represented on the committee though. Argentina, Hong Kong, Indonesia and Turkey (all emerging markets) are excluded. Most members have one representative (typically from the supervisory authority or central bank). A limited number of countries have two (France, Germany, Japan, Mexico, UK and Russia) or even three representatives (US). Also, a number of observers sit in the steering committee. These include the senior executives of IMF's Monetary and Capital Markets Department, Bank for International Settlements, European Central Bank and the Internal Market and Services Directorate of the European Commission. In addition, the chairmen of a number of international standard setting bodies (BCBS, IAIS, CGFS, IOSCO and IASB) are also represented as observers.[6]

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[5] See *Arner/Taylor* (2009) and *Giovanoli* (2009) for a detailed discussed on FSB's relation to G20, its mandate and role more generally).

[6] IAIS – International Association of Insurance Supervisors; IASB – International Accounting Standards Board; CGFS – Committee on the Global Financial System; IOSCO – International Organization of Securities Commissions.

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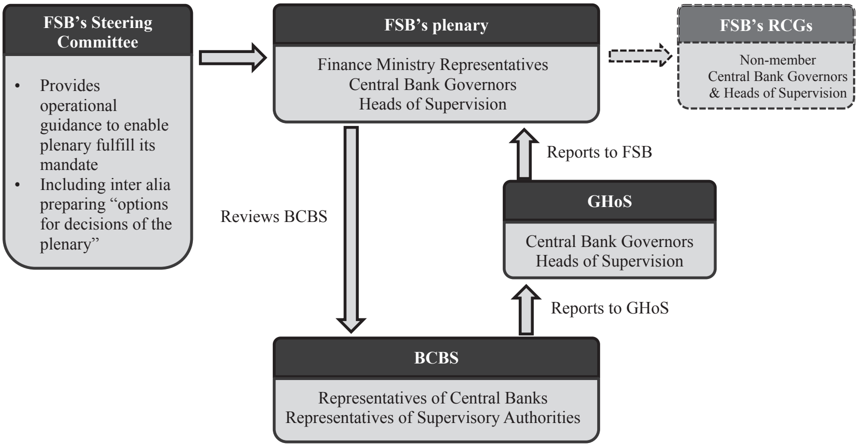

Figure 1: Organizational Links and Decision Making/Consultative Bodies of FSB and BCBS

In the context of this article, it is also worth mentioning that the FSB has established a number of Regional consultative groups (RCGs) to facilitate interaction with non-members and promote implementation of the various policy initiatives developed by FSB. These RGCs are constituted by between 7–23 countries each and represented the following regions: Americas, Asia, Commonwealth of Independent States, Europe, MENA and Sub-Saharan Africa.[7] While this means that many non-members and emerging markets in particular are provided a formal means of influencing FSB, it is questionable whether participation in a RCG yields in influence in practice. Figure 1 below illustrates the organizational links between the members of BCBS, GHoS and FSB.

In contrast to the original governance structure of BCBS that prevailed when the Committee developed its agreements on the Basel 1 and 2 accords, the revised governance structure of BCBS represents a major overhaul. The broadening of membership to include emerging markets represents one important change. The BCBS has traditionally been described as a standard setter not only lacking emerging market representation, but also deaf to the concerns and opinions of less developed countries

[7] In Europe, the Group of International Finance Centre Supervisors (GIFCS) – representing a number of small off-shore type financial jurisdictions are also represented. Likewise, in the Sub-Saharan Africa consultative group, the Central Bank of West African States is included.

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(*Claessens* et al (2008); *Underhill/Zhang* (2008) etc.). Also, whereas BCBS previously had implied an upward shift from nations to the global level in terms of banking regulation (*Underhill/Zhang* (2008); *Blom* (2009)), the reentrance of ministries in their capacity as members of the FSB in some ways represents a reclaim of power by politicians at the national level, despite the fact that some evidence suggests that politicans have indeed exerted informal power over the decisions of the BCBS.[8]

However, one can question the power of politicians in the steering of the FSB and thus the BCBS. Most FSB members merely have only a single representative at FSB's plenary, typically from the supervisory authority or central bank (see Table 1 below). This is particularly frequent for emerging market economies represented at the FSB. The powerful steering committee is also dominated by supervisors and central bankers. It is also noteworthy that those four FSB members that are not represented in the steering committee are all emerging market economies (Argentina, Hong Kong, Indonesia and Turkey).

One can thus question the influence of emerging market economies and the political sphere over the FSB and the BCBS. This may yet change in the near future. At Los Cabos, G20 also approved plans to strengthen FSB independence over time, through maintaining own headquarters and an own budget funded by membership fees (*Jones* (2012)). Arguably, this could reduce the influence of central bankers over time, since FSB would no longer rely on funding and office space from BIS. However, an altered governance structure was not the only change the global financial crisis brought about for BCBS. In response to the crisis, BCBS also embarked on developing the Basel 3 accord.

[8] Some evidence suggests that the old structure as was less apolitical than it looked. The BCBS has indeed at times succumbed to the wishes of politicians (c.f. *Barr/Miller* (2006)). Also, politicians have arguably stronger influence over supervisory authorities – which represent certain jurisdictions in the BCBS – than over central banks.

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Table 1

Member States Representation in FSB's Plenary and Steering Committee

	Plenary			Steering committee		
	Central bank	Treasury	Supervisory authority	Central bank	Treasury	Supervisory authority
Argentina	√		NA			NA
Australia	√	√		√		
Brazil	√	√	√	√		
Canada	√	√	√			√
China	√	√	√	√		
France	√	√	√	√	√	
Germany	√	√	√	√	√	
Hong Kong	√		NA			NA
India	√	√	√	√		
Indonesia	√		NA			NA
Italy	√	√	√	√		
Japan	√	√	√		√	√
Korea	√		√			√
Mexico	√	√		√	√	
Netherlands	√	√	NA	√		NA
Russia	√	√	√	√	√	
Saudi Arabia	√		NA	√		NA
Singapore	√		NA	√		NA
South Africa	√		NA		√	NA
Spain	√	√	NA	√		NA
Switzerland	√	√		√		
Turkey	√					
United Kingdom	√	√	√		√	√
USA	√	√	√	√	√	√

Source: FSB and World Bank Dataset on supervisory structures

Note: Information concerns the location of banking supervision. Supervision of other financial sectors may be conducted both within the central banks and by independent supervisory authorities.

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III. The Basel 3 Proposal

The main document of the Basel 3 accord was presented by BCBS in December 2009 (*BCBS* (2009b)). Resulting from intense negotiations, the proposal reformed the existing Basel 2 framework in three main ways: a) it refined existing standards; b) it expanded the scope of regulation; and c) it addressed well-known weaknesses of Basel 2. BCBS also outlined a number of policy areas for which proposals had not been finalized by December 2009, but for which the committee would continue to work and present proposals on in 2010–2011. Following some minor adjustments, the reform package was subsequently endorsed as GHoS reached a broad agreement on the Basel 3 reform package on 26 July 2010 (*BCBS* (2010a)).

1. Refinement of Existing Standards

The principal area of refinement concerned the raise in capital adequacy requirements and sharpening the definition of regulatory capital. While the total capital requirement of 8 percent of risk-weighted assets remained, the required levels for the highest form of regulatory capital increased sharply. The reform also package altered the type of capital instruments allowed into regulatory ratios, and introduced a number of additional prudential adjustments. The former sharpened the criteria for eligible capital instruments, ruling out some existing instruments, particularly hybrid capital notes. The latter included deducting (certain amounts above thresholds) assets in for investments in other financial institutions and insurance entities, mortgage servicing rights, certain deferred tax assets and intangible assets. New prudential adjustments also covered the liability side, as Basel 3 introduced adjustments for minority interests in consolidated subsidiaries.

BCBS also refined the existing standards regarding various risk metrics, in particular risk weights assigned to certain exposures. This included introducing risk weights for exposures to central clearing parties (CCPs) and mark-to-market credit valuation adjustments, for which both a standardized and an advanced method were permitted.[9]

[9] The changes in risk weights are typically referred to as Basel 2.5 since these reforms were presented prior to the principal Basel 3 document.

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2. Expanding the Scope of Regulation

The Basel 3 package also expands the BCBS' traditional focus on capital requirements (cf. *BCBS* (2009b)) to include global standards on liquidity. Two regulatory liquidity standards were introduced, and banks are expected to fulfill certain minimum levels for two liquidity ratios under normal conditions. The Liquidity Coverage Ratio (LCR) is a measure calibrated to measure a bank's ability to withstand a 30-day period of significant stress, where different types of funding are given different run-off rates. The Net Stable Funding Ratio (NSFR) is a measurement of the banks' liquidity mismatch. Different sources of funding are given different ratings depending on their perceived stability in times of turbulence, and available stable funding is put in relation to required stable funding in terms of assets with long tenor.

The Basel 3 package also introduces a Leverage Ratio, which limits the amount of assets (on- and off-balance sheet) a bank can hold given its amount of capital. Thereby, the leverage ratio is a simple, transparent measure that complements the risk-based capital requirements.

3. Addressing Well-Known Weaknesses

The committee also sought to address the procyclical nature of capital requirements under Basel 2; a familiar weakness (*Classens/Underhill* (2008); *Underhill/Zhang* (2008)) acknowledged even by the BIS (*Altman* et al. (2002)), that had played out severely during the build-up and spread of the crisis. Three principal measures were introduced in the Basel 3 reform package. One concerned adding a capital conservation buffer on top of the minimum capital requirements. The buffer aims absorb banking sector losses in case of a financial crisis. If a bank breaches the buffer requirements, it will be restricted in its ability to buy back shares and pay dividends or discretionary bonuses. Thereby, the buffer induces banks to conserve capital instead of cutting back on lending. Another component of Basel 3, with the aim of reducing procyclicality, is the requirements to use through-the-cycle probabilities of default (PDs) for banks that use the internal ratings approach to credit risk. Finally, the committee also introduced a requirement to use forward looking provisioning for expected loss to mitigate procyclicality.

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4. Further Policy Reform

In its December document, the committee also outlined a number of additional areas in need of reform that form part of the Basel 3 framework. One such proposal, on countercyclical buffers, also concerned the procyclical nature of capital requirements. The countercyclical buffer extends the range of the capital conservation buffer during periods of excess credit growth, to avoid detrimental deleveraging during downturns and reduce the building up of credit bubbles. Ensuring that capital instruments absorb losses in cases where banks are rescued by governments was also highlighted as an area of future reform. Similarly, the committee would also introduce a capital surcharge for globally systemically important financial institutions.

In the light of BCBS historical approach to banking regulation standard setting, the Basel 3 package can be seen as a partial retrenchment to a simpler approach to banking supervision. Whereas Basel 1 largely was founded on a command-and-control based approach (*Blom* (2009)), Basel 2 was based on more market-based techniques for supervision. This was apparent in that the Basel 2 both relied on market discipline through strengthening disclosure requirements, and allowed for the bank to develop advanced models to assessing risk and determining capital needs (subject to supervisory approval) (*Underhill/Zhang* (2008)). Basel 3 clearly proves a partial abandonment of these market-based principles, with the introduction of non-risk based measures (such as the leverage ratio) and by introducing required minimums in the banks' liquidity ratios.

IV. Basel 3 Consultation and Responses

Interested parties were invited to provide written comments on BCBS's December document (*BCBS* (2009)) by April 2010. A total of 213 responses were received from a wide range of stakeholders (see Figure 2 below).[10] Based on a classification of the responses according to the type of respondent, and whether origin of the respondent is an advanced

[10] This figure is adjusted to reflect the fact that some respondents sent in separate submissions typically on the regulatory proposals on capital and liquidity. In these cases, this counts as a single response. Also, some supervisory and regulatory authorities also submitted joint replies. In such cases, the organizations are treated as a single respondent.

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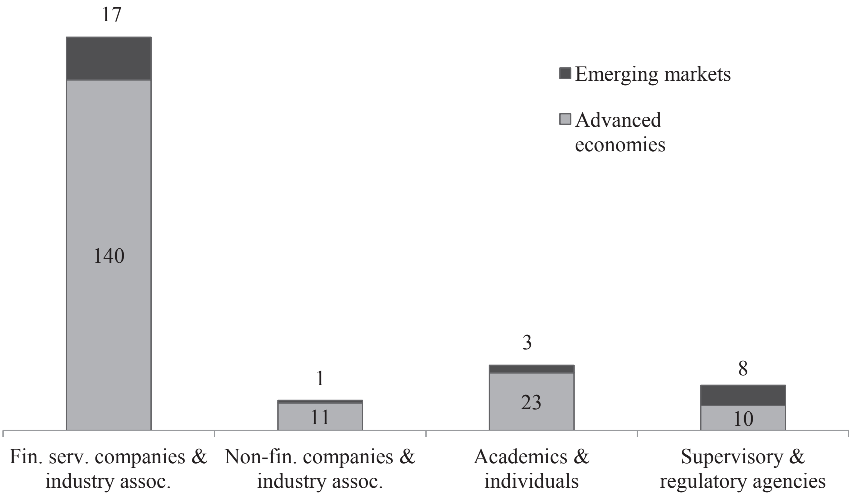

Source: author's own categorization based on BCBS data

Figure 2: Number of Consultation Responses by Sector and Type of Economy

economy or an emerging market, we looked for patterns in the consultation responses.[11]

Firstly, it is clear that financial services companies (dominated by Group 1 banks) accounted for nearly half (90) of all responses. Industry associations representing the financial services industry also constituted a significant amount with a total of 67 responses. BCBS received considerably fewer responses from the private sector outside financial services, including non-financial companies (3) and non-financial industry associations (9). Other groups of stakeholders also display low response rates, such as academics and other individuals (26) as well as supervisory and regulatory authorities (18).

It is also clear that pattern of responses between categories of countries (advanced economies and emerging markets) differed significantly. On an overall level, respondents from advanced countries represent a vast majority of responses (86%). While financial industry respondent dominated responses in both advanced economies and emerging market, response rates for supervisory and regulatory authorities differed mark-

[11] See footnote 2 for details on how countries were categorized as advanced economies or emerging markets.

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edly. In this category, almost half the responses came from emerging markets (8 out of 18). This is probably explained by the fact that most supervisory and regulatory authorities in advanced economies are either already members in BCBS or have other ways of influencing (through, for instance, through common organizations such as the EU).

In comparison with the process of Basel 2, the Basel 3 process displays both similarities and differences. Just as for Basel 2, the responses to the consultation were dominated by financial services companies or their industry associations. The latter accounted for ratio of nearly 74 % of all responses in the Basel 2 process (*Blom* (2009)), and the corresponding figure for the Basel 3 process was 77%. The striking difference appears in the number of responses from supervisory and regulatory authorities. Whereas these represented around 20% of all responses to the Basel 2 consultation, the figure had dwindles to around 8% in the Basel 3 process. This could, however, be attributable to the larger number of supervisory and regulatory authorities having gained formal access to the development of BCBS standards, due to the expansion of the committee. But once again responses from developing country and emerging market financial institutions (c.f. *Blom* (2009); *BBVA* (2011)), and influence from broader social constituencies (*Underhill/Zhang* (2008)) remained scarce. However, it is noteworthy that developing country representatives have shared their concerns with BCBS at a later stage (c.f. *Masters* (2012b); *Brunsden* (2012)).

1. Comments Received in the Consultation Process and Subsequent Changes to Basel 3

In terms of the actual content of the comments, most concerns were raised by the financial services companies and financial industry associations. While many respondents highlighted apprehensions with the cumulative impact of Basel 3, there were also a number of common themes observable in the consultation responses. The below paragraphs elaborate on these, and a number of subsequent changes made by BCBS to proposed reform package.[12]

The refinement of existing standards received little criticism in the consultation responses. Risk metrics for the calculation of various expo-

[12] It is important to bear in mind that Basel 3 leaves a number of areas open for further refinement and clarification, so any changes described in this section may be subject to future changes.

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sures (securitizations etc) attracted the most criticism. The comments on the new definition of capital were few. The most controversy arouse around the proposed prudential deductions of intangibles, deferred tax assets and minority interests.[13] The respondents believed that the full deduction of intangibles and deferred tax assets was unjustified, since some intangibles (e.g. mortgage service rights) tend to have value even under extreme stress situations. Criticism also surrounded the rules of capital adjustment for minority interest. The respondents highlighted that the rules would discourage foreign direct investments and lead to significant changes in organisational structures of financial conglomerates.

During summer 2010, BCBS and GHoS softened the requirements to fully deduct mortgage servicing rights, defored tax assets and minority interest (*GHoS* (2010)).[14] The so-called 'July compromise' was justified by fear that these deductions could have led to adverse consequences for certain business models and that full deduction may not appropriately take into account evidence of realizable valuations during periods of extreme stress.

The area where the reform package expands the scope of regulation, the proposal of uniform liquidity requirements was generally well-received. However, the LCR, which requires banks to hold highly liquid assets to manage an acute liquidity stress scenario for a 30-day period, was criticised on the basis of what constitutes a liquid asset and how run-off rates for various funding sources are specified. The reform proposal considered cash, central bank reserves and government securities as the principal liquid assets, while corporate bonds and covered bonds must meet certain criteria and are subject to haircuts (20% or 40%). Many respondents found the definition too narrow and argued that it might lead to supply shortages, especially in countries with low levels of government debt. The narrow coverage may also induce herding behaviour, since during the time of systematic distress everybody tries to sell the same assets. A wider range of non-financial corporate bonds was called for by many

[13] Prudential adjustments refer to the deduction of the accounting value of certain assets from the institution's capital base. Such adjustments concern assets that are deemed unsatisfactory from a prudential viewpoint.

[14] The new requirement means that bank need to deduct the amount by which the aggregate of the three items above exceeds 15 % of its common equity component of Tier 1 (calculated prior to the deduction of these items but after the deduction of all other deductions from the common equity component of Tier 14). The items included in the 15 % aggregate limit are subject to full disclosure.

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respondents. Many also expressed concerns about too broad classification of run-off factors.

BCBS responded by lowering the haircuts applied in the LCR on several assets, including government securities and certain non-financial corporate and covered bonds. The committee also responded to criticism by raising the weight given to retail and small and medium size companies' deposits in the NSFR. BCBS also clarified that both the LCR and the NSFR would subject to further testing during an observation period. The committee also decided on including a review clause to address any unintended consequences.

The leverage ratio proposal obtained most of the criticism. It was perceived as counter-intuitive (since it discriminates against low risk) and counter-productive (as it encourages risk-taking). A substantial increase in the funding costs of low risk banks was anticipated, while most respondents perceived that the effect on high risk banks would be none or minor. At country level, it was perceived as discriminating against countries with more traditional banking businesses. Accordingly, most criticism stemmed from European financial services companies and financial industry associations. Just as for the other area in which the committee expanded the scope of its regulation (the liquidity regulations), a transition period including a very open ended review clause was subsequently introduced.

In the areas where the reform package addresses well-known weaknesses and proposes areas of further reform, there were relatively few comments. The fact that neither counter-cyclicality nor systemic risk proposals rendered many comments was probably related to the fact that the proposed regulatory standards were far from being finalized and offered relatively little guidance on concrete measures.

In the next section, we assess the impact of Basel 3 on groups of banks and categories of countries. Thereafter, in the concluding section, we analyse whether there are any observable patterns in the governance of BCBS, the process of Basel 3 and the impact the reform package causes.

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V. Anticipating the Impact of Basel 3

1. Impact Assessments of Basel 3

BCBS published three main reports on the impact of the Basel 3 reform package; one which addressed what the immediate impact would be if the reform proposals would be applied on the banking sector under current conditions and without transitional arrangements. The committee, in collaboration with FSB and with the help of the IMF, also analyzed the transitional impact of the implementation process as well as the net social economic impact of stronger capital and liquidity reforms once all transitional arrangements are over and implementation is complete.[15] In this section, we focus on the first assessment (the 'BCBS QIS'), which sought to identify immediate effects if the whole Basel 3 package was instantly implemented (*BCBS* (2010d)). We also compare the findings of BCBS's impact assessments with those of other studies (such as *BBVA* (2011), *FSB* (2012b), *B20* (2012) and others). Naturally, BCBS's impact assessment does not reflect the true impact once Basel 3 is implemented. It does not take into account any transitional arrangements, adjustment of business models by banks or other changing conditions. However, in the context of this study, this is less of a problem since the impact assessment form the basis of the actual decision to endorse Basel 3 by BCBS members.

In terms of methodology, the BCBS QIS applied the new definitions, ratios and requirements (see previous section) to consolidated level data reflecting the standing of individual banks within its member countries by end 2009.[16] Data was submitted by the banks themselves, and there were no adjustments to reflect transitional arrangements, or changes in behavioral responses or profitability levels. Banks from 23 member jurisdictions participated. A total of 263 banks constituted the sample, out of which 94 were so-called Group 1 banks and the remaining 158 Group 2 banks. This grouping of banks follows BCBS traditional classification, where Group 1 represent well diversified internationally active banks with Tier 1 capital in excess of € 3 bn. Group 2 comprise all remaining banks in the member jurisdictions.

Using the results of QIS, we ask ourselves whether the results can be used to determine which countries and types of banks the reform pack-

[15] See *BCBS* (2010b; 2010c).

[16] The QIS was based on the definitions of the GHoS July compromise (*GHoS* (2010)).

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age favors. Since only banks in members countries were covered in the impact assessment, we are not able to assess how different countries worldwide outside the membership of BCBS could be affected.

However, by comparing the differences in impact between Group 1 and 2 banks, in combination with the distribution of the two banking groups over categories of countries, we get some indication of the impact of the reform. We choose to classify BCBS members into three such categories of countries: Traditional member countries – which represent the committees members prior to its expansion in 2009; EU member states – which represent a subset of the former BCBS-members consisting of solely European union members, and; Emerging market countries – encompassing primarily new members that are typically classified as emerging markets.[17] Looking at the distribution of Group 1 and Group 2 banks over these categories of countries, we can observe that of the total sample, 64% were Group 2 banks. The corresponding figures for traditional member countries and EU countries were 22% and 78% respectively. For emerging market countries, Group 2 banks accounted for 48% of all banks in the sample (see table 2).

Given the difficulties in drawing any conclusions from the results, we seek to distinguish patterns in the results that illustrate what types of banks and countries that benefited or are disadvantaged from the reform. Of course, we do not attempt to determine any net effects following the reform, but rather investigate the relative winners and losers. In the parts of the reform package that concern refinement of existing standards, we also contrast the findings with the corresponding impact assessment BCBS conducted in concordance with the establishment of Basel 2 (*BCBS* (2003)). By doing so we seek to confirm or reject notions from prior research on whose interests BCBS primarily serve.[18]

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[17] According to the classification of emerging markets discussed in Section 2 (footnote 2), the following emerging market countries are members of BCBS and included in BCBS's quantitative impact assessment (2010d): Brazil, China, India, Korea, Mexico, Saudi Arabia and South Africa.

[18] Since the QIS (*BCBS* (2010d)) does not cover areas in which Basel 3 addresses well-known weaknesses or areas of future policy reform, we limit our analysis to the impact of refinement of existing standards and the expansion of the scope of the regulation.

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Table 2

Distribution of Group 1 and Group 2 Banks Across Traditional Member Countries, EU Member States and Emerging Markets Countries

Category	No of banks	No of Group 1 banks (%)	No of Group 2 banks (%)
Traditional member countries	193	63 (33%)	130 (67%)
EU member states	148	33 (22%)	115 (78%)
Emerging market countries	41	21 (52%)	20 (48%)
Total	263	115 (36%)	158 (64%)

Source: own calculations based on *BCBS* (2010d).

Note: When considering these interpretations, one has to bear in mind the banks that form part of the QIS only represent a sample of all banks in many countries. Thus, the actual distribution may differ. Also, the data reports number of banks, and says nothing on the actual market shares in credit market. In addition, there may be considerable intra-Group differences in terms of the banks' business models, technological levels etc. In its national implementation, Basel 3 may also differ and not necessarily apply to cover Group 2 banks in all jurisdictions.

2. *Basel 3 – Who Gains? Who Loses?*

The parts of Basel 3 that represent a refinement of existing standards already included in Basel 2 seem to favor Group 2 banks. This concerns both the new definition of the capital ratio (CET1) and effects from altered risk metrics in the shape of changing risk weights for the banks' assets. For Group 1 banks, the average decrease in capital ratios (CET1) was 5.4 percentage points. This represented a fall from an 11.1% ratio to an average ratio of 5.7%. Group 2 banks' decline was only 2.9 percentage points – from 10.7% to 7.8%. A similar pattern is observable in the ratios of total capital for the two groups of banks. The risk-weighted assets increased by 23% for Group 1 banks, whereas the increase for Group 2 banks was limited to 4% (see table 3 below). Differences between the groups of banks were primarily attributed to differences in terms of counterparty and trading book risk.

The expansion of the scope of regulation to new areas also represents a relative benefit for Group 2 banks in comparison to their peers in Group 1 (see table 4 below). The former display a leverage ratio of 3.8% whereas the ratio of Group 1 banks amounted to 2.8%. Also, Group 2

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Table 3

Impact on Group 1 and Group 2 Banks by Refinement of Existing Standards

Refinement of existing standards	CAPITAL ADEQUACY REQUIREMENTS				RISK METRICS (changes in RWA)
	Core capital – Basel 2	Common Equity Tier 1 capital – Basel 3	Total capital – Basel 2	Total capital – Basel 3	
Group 1	11.11	5.7	14.0	8.4	+ 23%
Group 2	10.7	7.8	12.8	10.3	+4%

Source: BCBS (2010d).

Note: The terminology of regulatory capital changed with the introduction of the Basel 3 accord, in which the most loss absorbing form of capital is denominated Common Equity Tier 1.

Table 4

Impact on Group 1 and Group 2 Banks by Expanding the Scope of Regulation

Expanding the scope of the regulatory parameter	LR	LIQUIDITY REQUIREMENTS	
		LCR	NSFR
Group 1	2.8	83%	93%
Group 2	3.8	98%	103%

Source: BCBS (2010b).

banks obtain a LCR of 98% and a NSFR of 103%. Again, Group 1 banks come out lower with 83% and 93% respectively.

The above observations from BCBS impact assessment unequivocally point to Group 1 banks faring relatively worse off in comparison with their peers in Group 2. The significant effect on Group 1 banks is also corroborated by other research (see *Cosimano/Hakura* (2011) for an overview). This effect is most likely a consequence of the fact that the latter typically operate in less complex conglomerate structures, and issue complex capital instruments less frequently. A larger part of their assets are traditional banking loans and fewer assets are used in complex transactions and for trading purposes. Also, Group 2 banks seem to rely on more long term funding, including deposits.

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These findings contrast those of the impact assessment that BCBS conducted in 2003 as the Basel 2 framework was in the process of being finalized. The 2003 assessment clearly showed that the introduction of the ratings based approaches, Group 1 banks were able to lower their risk weighted assets (RWAs) to a much higher extent than Group 2 banks. This was particularly true for Group 1 banks domiciled in the European Union (*BCBS* (2003)).

Cross matching the results with the distribution of Group 1 and 2 banks over categories of countries, the Basel 3 reform seem to provide relatively higher benefit for banks in traditional BCBS member countries in comparison to banks in emerging market economies. However, these results should be interpreted with caution. They merely represent a snapshot picture that does not take into account the banks' opportunities to adjust their structure and business models to the changing regulatory environment. In general, Group 1 banks are probably in a better position to circumvent the impact through various regulatory and structural setups. Also, as discussed above, the true distribution of effects may well differ depending on the nature and actual number of Group 1 and 2 banks, as well as how they are regulated, in each category of and individual countries. For instance, the actual sampling of banks that were included for each jurisdiction may have varied considerably.[19]

Taken at face value, however, the above findings seem to suggest that Basel 3 is less harmful for less developed banks. This contrast findings on the impact on the banking industry of Basel 2 (*Bailey* (2005); *Claessens* et al. (2008); *Underhill/Zhang* (2008)) that point to the favorable outcome for large banks with access to sophisticated risk-management technologies and skills. If any conclusion can be drawn from the relative distribution of Group 1 and Group 2 banks in developed and emerging market economies, the evidence presented in the impact study on Basel 3 seem to indicate that emerging market economies, with their lower proportion of Group 2 banks, should lose out relative to developed countries from the accord. This corresponds to the impact of Basel 2 (*Bailey* (2005); *Claessens* et al. (2008)). It is also noteworthy that banking sectors in EU member states seem to reap the largest relative benefits from Basel 3, at

[19] BCBS highlights this fact by the following statement "Members' coverage of their banking sector was very high for Group 1 banks, reaching 100 % coverage for some jurisdictions, while comparatively lower for Group 2 banks and varied across jurisdictions" (*BCBS* (2010d:5)).

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least based on fact that their ratio of Group 2 banks is the highest among the three categories of countries. However, as pointed out by *Cosimano/Hakura* (2011), there can be considerable variation within categories of countries, not least due to the impact of different business models at bank, as shown by *Masera* (2011). Also, the actual sampling used by BCBS members in their respective jurisdiction may differ, and could mean a systematic skewedness of the overall sample.

It is also important to remark that the economic effects considered above merely include direct effects on banks' balance sheets. Below, the findings are compared to a number of other studies on the effects of Basel III on banks and economies.

3. Are Advanced Economies Really (Relatively) Better Off?

The findings of BCBS's impact study are supported alternative assessments of the impact of Basel 3 on different categories of countries. According to *BBVA* (2011) the negative impact on economic growth in emerging markets will be disproportionally larger; whereas global growth would be reduced with 2% following a 20% increase in capital (an assumption reflecting Basel 3 requirements), growth in emerging market would fall by 3%. This finding is also corroborated by a number of non-quantitative qualitative assessments. According to these assessments, emerging markets will be more severely impacted than developed countries through both direct and indirect effects. The direct effects concern impact on local banks in emerging markets, whereas indirect effects work through impact on the global financial system in general and the operations of foreign banks in EMs in particular (c.f. *B20* (2012); *Ghosh* et al. (2011); *Takáts/Villar* (2011).

Several reason why the direct effects are estimated to be even more severe in emerging markets compared to traditional BCBS are highlighted in the non-BCBS assessments. One is that the Basel 3 according is more difficult to implement (*Masters* (2012a)). The scarcity of eligible debt instruments in a number of Asian countries with low levels of national debts (*Takáts/Villar* (2011)) and countries with undeveloped bond markets (*Masters* (2012a)). Also, liquidity regulation may result in in lower cross-border and domestic bank lending in EMEs (*Takáts/Villar* (2011)). Undeveloped bond markets also mean that the availability of alternative credit channels to traditional banks is low in many emerging markets

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(*BBVA* (2011)).[20] Another reason is that emerging market banks have fewer opportunities to hedge against credit risk through credit derivatives (*Masters* (2012a)).

There are also more specific reasons why emerging and developing countries will be more severely impacted by the Basel 3 accord highlighted in the debate. Many voices have raised concern that trade and project finance will become more expensive for large international banks, which will hit export-oriented emerging markets and countries that are in need of large infrastructure investments disproportionally (*B20* (2012)). However, according to the results of a survey conducted by *FSB* (2012b) local banks are ready to step in and fill any credit shortage following the Basel 3 accord in these areas. Yet, some evidence seems to suggest that trade finance has suffered from the anticipated Basel 3 rules (c.f. *Economist* (2012a)).

Indirect effects on emerging markets include the risk of banks domiciled in developed countries pulling out of emerging and developing markets, and thereby cutting competition and raise the cost of credit (*B20* (2012)). But again, according to the *FSB* survey (2012b), there are few signs of banks develeraging in those categories of countries.[21] In conclusion, the FSB survey seems generally to contrast the findings of BCBS impact assessment. There is also anecdotal evidence from other sources that suggest that banks from less advanced and emerging markets are expanding their operations as a result of banks struggling in Europe and the US (*Economist* (2012b)).

VI. Discussion

The literature on the international financial architecture suggest that rules for the financial industry are set by unaccountable bodies, strongly influenced by the financial industry, in favor of their home countries. In this article, we have reassessed the above notions by studying BCBS's third capital accord (the so-called Basel 3). Taken together, the findings presented in the above sections suggest that BCBS has undergone a rather profound change in terms of its governance, its standard setting pro-

[20] However, one should remember that bond markets are highly developed in many emerging markets (c.f. *Correira* et al 2009).

[21] Also, other research suggests that emerging markets within EU are less affected by Basel 3 than their more advanced counterparts (c.f. *Nucu* (2011)).

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cess and the way its capital accords impact the global financial community and various countries.

BCBS can no longer be described as an unaccountable independent standard setter that is deaf to the concerns of all but the financial industry; Even if political interest probably could exert informal influence on the committee's decisions before, the establishment of FSB with formal representation of political interest can only be described as a major overhaul. This is the case even if central banker still dominate FSB's powerful steering committee. In addition, the broadened membership of BCBS to include emerging markets, and to some minor extent also the establishment of regional consultative groups, represent an important change.

However, the process by which Basel 3 was established displays significant commonalities with the process of BCBS's preceding accords. Private interest still seems to exert considerable influence the process by which Basel 3 was established, even if the extent of informal influence cannot be observable or measured. Judging by the changes made by BCBS to the original proposal, private interest seems to have been relatively successful in inducing changes it desired. Nonetheless, the outcome in the shape of Basel 3 nevertheless represent a retrenchment to the regulatory approach that characterized BCBS' first accord in that it (at least partially) provides less leeway for banks and includes more command-and-control like features (such as the leverage and liquidity ratios).

Regarding the impact of Basel 3, BCBS anticipated that less advanced banks, and countries who harbor them, would benefit in relative terms. Evidence presented in the impact study on Basel 3 seem to indicate that emerging market economies, with their lower proportion of Group 2 banks, should lose out relative to developed countries from the accord. This again corresponds to the anticipated impact of Basel 2, but with the important difference that more advanced banks seem to have become more common in emerging markets. Whether this is due to sampling or industrial developments in these countries cannot be determined using publicly available data. But the important aspect is that BCBS used their impact assessment as a basis for their decision to push ahead with Basel 3.

While some scholars and others have attributed the outcomes of BCBS's previous accords to its opaque governance structure, exclusionary nature and secretive mode of interacting with few outsiders other than representatives of large financial institutions, the above findings make no

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claim on such causality. However, what is clear is that the global financial crisis has a profound effect on BCBS in terms of governance. A tilting of power in favor of emerging markets and publicly accountable authorities has occurred. It is at least not unlikely that that it did affect what Basel 3 meant in terms of economic impact on various types of banks and indeed countries. And taken together, this may suggest that the political economy of banking regulation indeed has changed.

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